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THE PRINCIPLES AND POLITICS OF TAX REFORM

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INTRODUCTION

THE PRINCIPLES AND POLITICS OF TAX REFORM

James A. Dorn

> When Congress gets into the business of figuring out $370 billion of tax breaks a year, the House Ways and Means Committee and the Senate Finance Committee really are put in the business of trying, at least partially, to plan the American economy. . . . I confess that I am not qualified to act as a central planner and I do not know anybody on either committee who is. They are all wonderful people, great Americans. They all mean well. But the fact of the matter is that when the details are all put together, I am convinced that we do not have the foggiest notion of what we are doing in terms of the total economic outcome.
>
> —Rep. Richard Gephardt[1]

Effective tax reform requires both sound principles of public finance and political acceptability. Supply-side tax policy is characterized by the proposition that lower marginal tax rates stimulate economic growth and that this may increase real tax revenues over time. To the extent that this proposition is empirically validated, supply-side tax policy will be more likely to command political support, making it feasible to adopt a flat rate tax. Public choice theory cautions, however, that sound tax principles and pragmatic politics seldom go together—unless reform includes *constitutional* change that limits the taxing and spending powers of government.

The 1985 tax reform debate is evidence of the disparity between sound tax principles and the democratic political process. The major tax reform proposals emphasize the need for tax simplification, lower marginal tax rates and a broader base to increase efficiency, and a

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[1]Gephardt (1985, p. 458).

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fairer treatment of equally situated individuals to improve equity.[2] These objectives, however, have become entangled in the political process as special interest groups vie for taxpayers' wealth. The prospect of meaningful tax reform in the near term, therefore, is questionable. Even so, the tax reform debate has raised important issues regarding the principles and politics of tax reform, issues that deserve serious consideration if long-run reform is to be achieved.

The papers in this volume—originally presented at a conference on flat rate taxation sponsored by the **Florida State University Policy Sciences Program** (14–15 March 1985)—discuss the major tax reform proposals from both a positive and a normative viewpoint. Efficiency is treated within the framework of the traditional theory of optimal taxation as well as within a public choice setting, and matters of equity are considered from a property rights perspective. An idea running throughout this volume is that there is a close link between the tax regime, individual incentives to work, save, and invest, and the allocation of resources. Whether supply-side tax policy can bring about meaningful reform, however, is seen to be conditioned by the constitutional limitations on the state's taxing and spending powers, as shaped by the political process in a democratic setting.

Although the authors differ on what constitutes a "good" tax system, they agree that the current Brobdingnagian tax regime merits reform. Emphasis is placed, therefore, on evaluating the flat rate tax as an alternative to the progressive income tax. In order to provide the broader perspective necessary to understand and evaluate the flat rate tax issue, the remainder of this introduction will consider the rationale for tax reform, the principles underlying tax reform, the political difficulty of achieving permanent tax reform, and the case for constitutional tax reform. The current status of the tax debate as treated by the authors in this volume will then be summarized.

Rationale for Tax Reform

The complexity of the current tax code, the heavy burden of taxation on all income classes, the inefficiency of the high marginal tax rates on labor and capital income, and the uncertainty and inequity caused by the loophole-plagued progressive income tax system are all important reasons for tax reform.

[2]See Thorning (1985) for a discussion of the tax reform proposals before the 99th Congress.

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Complexity of the Tax Code

In 1913, when the Sixteenth Amendment to the U.S. Constitution became effective, the federal income tax code filled less than 20 pages; today it fills many volumes and along with numerous rules and regulations occupies thousands of pages.[3] The growing complexity of the tax code has led to a profitable tax-service industry as bewildered taxpayers seek the advice of countless tax attorneys and accountants. Indeed, one of the political hurdles that any sensible tax reform must surmont is the hungry tax-service lobby, which has little reason to promote tax simplification.

Social engineering has become the essence of the federal tax system. Instead of directly financing public services that are socially beneficial, the tax code has become an instrument by which legislators seek to influence social policy, whether it is to promote reindustrialization or to encourage home ownership. The numerous "tax expenditures" atest to the influence of special interest groups and have unduly complicated the tax system.[4] In such a system, it often becomes more profitable to lobby for tax loopholes than to engage in socially productive activities.

The complexity of the tax system is aptly illustrated by the Deficit Reduction Act of 1984. According to Gephardt (1985, pp. 461, 464):

> [This law] was 1,300 pages long. It was a so-called loophole closing bill designed to raise revenue. When the regulations are completed, if they ever are—five or ten years from now—they will be another three or four or five thousand pages. It looks like what we are really trying to do is write a code for each person in the country. . . . The whole idea of trying to run this country in part by a commmittee of 535 people is audacious when you really step back and look at it. With a population of 250 million people, we have a committee of 535 people trying to decide how something as complicated as a tax system should work. I really think it works only if, from time to time, we arrive at a consensus in our democracy that says, "What

[3]The federal income tax was enacted 3 October 1913, as part of "An Act to Reduce Tariff Duties and to Provide Revenue for the Government, and for Other Purposes" (H.R. 3321, enacted as P.L. No. 16). Section II of that act, known as the *Tariff of 1913*, was devoted to the income tax. Its total length was 15 pages. See *U.S. Statutes at Large* (1915, pp. 166–81).

[4]Tax expenditures are special provisions of the tax law designed to encourage various activities by providing tax relief. They include the Accelerated Cost Recovery System (ACRS), the Investment Tax Credit (ITC), the lower tax rates on capital gains, and the deductibility of mortgage interest payments. Although tax expenditures add complexity and often lead to horizontal inequity, they may offset existing biases in the tax code. Thus, Egger (1985, p. 5) argues that the ACRS and ITC help offset the "inefficient tax-induced bias against capital investment."

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> we have got here is not working. We need to return to something that will be more effective."

One of the basic reasons, then, for reforming the current tax system is its overwhelming complexity. A movement away from using the tax code for social engineering and toward a simple tax system designed to raise revenue for the provision of genuine public services would help create a more rational tax code.

Excessive Taxation

In 1984 the federal government drained off 19.2 percent of the gross national product (GNP) in taxes compared to 20.4 percent in 1979 and 20.9 percent in 1969. Over the last 15 years, therefore, the federal tax burden has remained roughly the same. But when compared to an earlier period, say 1929, in which federal tax receipts were 3.7 percent of GNP, the enormous growth in the federal tax burden is evident.

A more accurate measure of the federal burden is the size of federal spending as a percent of GNP. This ratio was 24 percent in 1984, 21.1 percent in 1979, 20 percent in 1969, and 2.5 percent in 1929. From this perspective, the burden of the federal government has increased in the last 15 years, and increased dramatically since 1929.[5]

Ideally, taxes should reflect the marginal benefits received from government spending programs. If a new expenditure program cannot generate sufficient benefits to cover its costs, it should not be enacted. The linking of marginal benefits and costs is essential for a sound fiscal regime. Under the existing congressional budget process, however, the two sides of the federal budget largely are divorced. Together with strong political incentives to hide the cost of government (either by deficit financing or moving items "off-budget") and to concentrate benefits, the separation of spending and taxing decisions invariably leads toward excessive federal spending and, hence, eventually to excessive taxation.

If the full burden of government spending programs—including the high cost of regulation—were placed squarely on the shoulders of present taxpayers, it is highly probable they would rebel, just as colonial taxpayers rebelled against the burden of British taxes and regulations. More pointedly, President Reagan's landslide victories in 1980 and 1984 were based in large part on his promises to reduce the size of government and the oppressive tax burden—neither of which has been achieved.

[5]The figures for federal taxing and spending were obtained from the *Economic Report of the President* (1985, p. 66).

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As the debt burden grows to $2 trillion and the deficit approaches 5 percent of GNP—it was 4.8 percent in 1984 versus 0.7 percent in 1979, −0.9 percent in 1969, and −1.2 percent in 1929[6]—it will become increasingly difficult to rely on deficit financing to hide the high cost of government. Popular pressure is likely to build for fiscal conservativism, but reducing spending and/or increasing taxes will not necessarily limit the future growth of government. Without constitutional limits on the size of government, it seems unlikely that the greed of legislators and special interest groups for power and privilege will be effectively curtailed. Indeed, the hidden agenda of "tax reform" often appears to be the *increase* of government revenue, not the reduction in the scope of government power.

Therefore, while government spending continues to climb, taxes remain relatively constant as a share of GNP. In the meantime, federal deficits push tax liabilities into the future, allowing myopic politicians to postpone the day of reckoning. Rather than risk political suicide by attempting to balance the budget by cutting spending or increasing taxes, politicians much prefer to ignore hard realities and make believe there is a free lunch, perhaps in the form of the more naive supply-side theory. But taxpayers are restless, as evidenced by the grassroots drive for a balanced budget amendment, and the stage is being set for meaningful tax reform combining genuine supply-side principles with constitutional economics.[7]

Inefficiency of the Federal Income Tax

The preferential tax treatment of various types of capital assets, the high marginal tax rates under the progressive income tax, the differential treatment of corporate and noncorporate income, and numerous other facets of the federal tax code distort the relative price structure, alter incentives to work, save, and invest, and politicize the allocation of resources. The non-neutrality of the current tax regime, therefore, disturbs the normal flow of resources: human and nonhuman capital as well as entrepreneurial ability are not allocated in accordance with consumers' preferences and, thus, do not attain their highest-valued uses. Under the current tax regime, resources also are wasted lobbying for tax expenditures and complying with the bewildering tax code. A less complex tax code integrating the personal income tax and the corporate income tax and lowering

[6]*Economic Report* (1985, p. 66).

[7]Perhaps it is the fear of real tax reform—limiting the size and power of government—that created congressional support for the Gramm-Rudman-Hollings "Balanced Budget and Emergency Deficit Control Act of 1985" (H.J. Res. 372).

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marginal tax rates on income from all sources would allow a more efficient allocation of resources than the present system.

Tax efficiency also requires that individuals pay taxes in line with their marginal evaluations of the services provided by government. Insofar as taxes exceed what individuals voluntarily would consent to pay for the public services, government spending and taxes will be excessive—too many resources will be forced into the public sector, diverting them from higher-valued private uses.[8] In principle, then, an efficient tax system should resemble a voluntary exchange economy in which prices reflect consumer's willingness to pay, that is, their marginal evaluations of the private goods.

The existing tax regime significantly deviates from the marginal benefit principle of taxation, fails to link taxes to expenditures, and relies almost wholly on the ability to pay principle of taxation. In particular, without any constraint on the government's power to tax, the ability to pay principle has allowed the state to devour taxpayers' wealth without rendering reciprocal services. The modern redistributive state attenuates private property rights and leads to a tax burden whose size and distribution would not emerge from a consensual process. And as Brennan and Buchanan (1980) have emphasized, once it is recognized that the modern democratic state may be a revenue maximizer, more citizens will come to understand why the tax regime will be continuously altered to increase revenues beyond the point of taxpayer consensus, leading to an inefficient allocation of resources and excessive government.

Although the democratic political process cannot duplicate the competitive market process, instituting the following measures would help generate a fiscal regime that is more consistent with the principle of voluntary consent and corresponds more closely with taxpayers' preferences for a simpler, more efficient, more equitable tax system: (1) limit the size of government by fixing the federal tax share as a percent of GNP; (2) replace the progressive income tax with a flat rate tax on either consumption or income; and (3) require a balanced federal budget. With these reform measures, individual tax shares more nearly would reflect both the marginal benefits received from public services. The closer link between taxing and spending would tend to generate a more acceptable tax burden than presently

[8]Wicksell (1896) developed the principle of voluntary consent to guide tax policy and Lindahl (1919) further developed this principle in the context of a voluntary exchange model of taxation, showing that efficient taxation requires that marginal tax prices be equal to the marginal benefits received from the public expenditures; the sum of the marginal benefits will then cover the marginal cost of the public good. See Wagner (1983) for a modern treatment of these ideas.

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exists. Constitutional tax reform in the context of supply-side tax policy is likely, therefore, to improve efficiency in the sense of promoting a fiscal regime that is more consistent with private sovereignty.[9]

Uncertainty and Inequity of the Existing Tax Regime

The non-neutrality of the existing tax regime, its inefficiency, and its complexity have increased greatly the uncertainty about future tax shares. The tax code and its administrative rules and regulations can change at any time, making it very costly to predict one's future tax share. Not only are future tax rates uncertain, so are the activities that will be subject to these rates. This is especially true in the corporate sector where tax rules are changed almost on a yearly basis.[10] In such a climate, investment becomes even riskier and an entrepreneur's long-range decisions will be conditioned strongly by his perception of the future tax structure. Those entrepreneurs who are politically astute will survive compared to those who are market-oriented but politically naive. Investment resources will tend to flow more often to those companies whose executives are successful lobbyists rather than to entrepreneurs who anticipate consumers' demands and who ordinarily could undersell their rivals. The inequity that arises from this politically induced uncertainty surrounding the fiscal regime is a significant justification for tax reform.

Currently, individuals with similar incomes can pay widely different taxes depending on their knowledge of the tax code and their success in exploiting tax loopholes. Those who are unable to influence tax policy will lose out to those who successfully gain tax preferences. In this environment, rent-seeking and wealth redistribution will be rewarded rather than profit-seeking and wealth creation.

When the tax system primarily becomes an instrument for redistributing income and wealth rather than for collecting revenues to supply genuine public services (such as the safeguarding of private property rights), incentives to work, save, and invest will be weakened, slowing the wealth-creating market process. Under the progressive income tax, the government has become a redistributive agent for special interest groups rather than a referee who enforces

[9]See Pilon (1985) for a discussion of private sovereignty within a rights-based approach to government activity. Essentially, private sovereignty requires a regime of private property rights and freedom of contract, limiting coercion to the protection of these rights.

[10]For example, the ITC was "instituted in 1962," but "modified in 1964, suspended in 1966, restored in 1967, repealed in 1969, reenacted in 1971, liberalized in 1975 (first temporarily), and slightly changed in 1981. In 1982, the ITC was changed again" (CBO 1984, p. 21).

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the rules of the game so that everyone is treated equally under the law. The principle of end-state (or distributive) justice has replaced the liberal rule of law tradition with its emphasis on procedural (or process) justice and private property rights.[11] Thus, the ability to pay principle of taxation has come to dominate the benefit principle, attenuating private property rights in the process.[12]

The progressivity of the federal income tax is "justified" by an appeal to end-state principles of justice and an invalid interpersonal utility comparison between high- and low-income taxpayers. When the veil of technical jargon is lifted, however, it is clear that progressive taxation cannot be justified from a property rights perspective because it would permit a majority to exploit a minority without the latter's consent. As Hayek (1960, p. 322) points out:

> That a majority should be free to impose a discriminatory tax burden on a minority; that, in consequence, equal services should be remunerated differently; and that for a whole class, merely because its incomes are not in line with those of the rest, the normal incentives should be practically made ineffective—all these are principles which cannot be defended on grounds of justice.

When tax policy is used as a form of social engineering or industrial policy to reward those individuals and firms with the greatest political influence, it cannot help but be inequitable as well as inefficient. Indeed, if justice and efficiency are viewed in terms of voluntary consent, it could be argued that the current tax system is neither efficient not just.

The effects of a fiscal regime that gives primary attention to redistribution rather than to protection of person and property was recognized clearly by Bastiat (1964 [1848], pp. 128–29):

> [When] the state is responsible for establishing fraternity [distributive justice] on behalf of its citizens, we shall see the entire people transformed into petitioners. Landed property, agriculture, industry, commerce, shipping, industrial companies, all will bestir themselves to claim favors from the state. The public treasury will be literally pillaged. Everyone will have good reasons to prove that legal fraternity should be interpreted in this sense: "Let me have the benefits, and let others pay the costs." Everyone's effort will be directed toward snatching a scrap of *fraternal* privilege from the legislature. The suffering classes, although having the greatest claim, will not always have the greatest success. . . .

[11]See Brunner (1983) on the difference between end-state justice and procedural justice and on the implications of each for political institutions.

[12]See Wagner's paper in this volume.

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It is widely agreed that the current tax system is unfair in the sense of treating equally situated individuals differently and creating great uncertainty about future tax shares. What is not agreed on, however, is what the best distribution of the tax burden ought to be. Indeed, no consensus is likely to be reached on this question as long as an end-state approach is taken to determining the "just" distribution of the tax burden and as long as taxing and spending decisions are dichotomized. When taxpayer wealth is viewed by legislators as common property to be preyed on by special interest groups, the budget process is bound to become dominated by political factors rather than grounded in sound principles of finance and justice.

Returning to a more fundamental view of tax equity—a view that considers justice from a procedural perspective rather than from an end-state perspective—would require taxpayers to reconsider their choice of fiscal regimes from a constitutional or property rights perspective. The debate over tax reform then becomes a constitutional debate about the role and size of government. It is this type of "constitutional tax reform" that is the real route to a just system of taxation and meaningful tax reform.[13] The constitutional route, however, is the route that Congress and special interest groups have little incentive to take.

Principles of Tax Reform

Meaningful tax reform requires an analytical framework based on the following four principles: (1) taxes should be simple so that they are widely understood; (2) taxes should reflect the marginal benefits received from public services so that taxes will not be excessive; (3) taxes should be as neutral as possible in order not to distort the structure of prices and production and as efficient as possible in order not to violate the principle of voluntary consent; (4) taxes should be foreseeable and equitable to ensure a stable fiscal regime, equal treatment of equally situated taxpayers, and consensus in the choice of fiscal regimes.

A Simple Tax Regime

A tax regime should be simple enough to allow taxpayers to understand it and comply with the law. They should be able to calculate their own taxes and prepare their tax returns without an army of tax attorneys and accountants and without a large Internal Revenue

[13]See Brennan and Buchanan (1980, ch. 10) for a discussion of the importance of constitutional tax reform.

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Service (IRS) administering the tax code. A flat rate tax on consumption or income would be less costly to comply with and to administer than the existing graduated income tax. From the viewpoint of simplicity, then, a single, proportionate tax on consumption or income would be preferable to the current multi-rate, progressive income tax with its numerous loopholes. For example, a broad-based flat tax would allow both individuals and corporations to simplify their tax accounting by using the postcard-sized tax forms devised by Hall and Rabushka.[14]

Under a simplified tax system, Congress would not have to continuously alter the tax code and the resources now tied up in the tax-service industry could be released for more productive uses. If there were a flat rate tax with a uniform rate, Congress need only decide in advance on the tax rate for the coming year. Moreover, if a *permanent* tax rate (expressed as a percentage of GNP) were incorporated into the Constitution along with a balanced-budget amendment, there would be little for Congress to do except to decide how the resulting revenue would be apportioned among competing demands. The present social-engineering approach to taxation would no longer survive under constitutional tax reform, as rent-seeking for tax preferences would become unprofitable.[15] Constitutional tax reform, which would make it relatively easy for individuals to determine their future tax shares, is therefore the most lasting route to tax simplification.[16]

It is doubtful if the adoption of a flat rate tax, either on consumption or income, would be accompanied by a balanced-budget amendment. Nevertheless, adopting a flat rate tax now might help pave the way for constitutional tax reform as some future date.

An Acceptable Tax Burden

In the market exchange process there is a direct relationship between the price paid for a good and the individual's marginal evaluation of

[14]See the paper by Hall and Rabushka in this volume.

[15]It is assumed that a constitutional tax reform would generate a consensus for a flat tax with a significantly lower marginal tax rate, thus minimizing incentives to create new tax loopholes.

[16]Perhaps the first American economist to recommend a flat rate tax to achieve tax simplification was Erick Bollmann who in 1812 advocated a 1 percent tax on "net revenue," which he referred to as the "Union Tax." Bollmann argued that such a tax—levied at a *"uniform per centage on the net revenue of every individual, enjoying an income in his own right"*—would reduce significantly the "financial labours of [C]ongress" because Congress would only have to fix the rate of tax each year. He thought that his Union Tax should eventually be incorporated into the Constitution (Bollmann 1812a, pp. 250–51, 255, 257, 259). [Although Bollmann's 1812a essay is unsigned, he is the most probable author given the fact that there are cross references between this article and a successive article in the same journal, which has been attributed to Bollmann (1812b).]

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it, that is, between price and marginal benefit. The consensual market process assures this correspondence. Insofar as the fiscal exchange process is characterized by voluntary consent, individual tax shares will reflect the marginal benefits received from publicly provided services. Determining an *acceptable* tax burden, therefore, ultimately requires a correspondence between taxes paid and benefits received, just as in the private-goods case. Thus, taxes should reflect the marginal benefit principle of taxation if the tax regime is to avoid excessive taxation. From this perspective, tax reform should aim at achieving a greater consensus regarding tax shares by linking tax shares to spending decisions.

A flat rate tax on income or consumption and a constitutional limitation on taxes as a share of GNP, together with a balanced-budget amendment, would provide a closer link between government spending and tax shares. Until government's power to tax is limited and the full cost of government is reflected in individual tax shares, which also reflect the marginal benefits received from public services, tax reform is unlikely to reduce the true burden of taxation, that is, the percent of GNP devoted to government spending.

Tax Neutrality and Efficiency

The government should attempt to minimize the substitution effects of the tax regime, so that in raising revenue private activities and decisions are distorted as little as possible. This neutrality ideal will be approached as the tax regime approximates a voluntary exchange process. The difficulty of achieving unanimity in the fiscal exchange process is well known; thus, in discussing neutrality and efficiency, it is more appropriate to compare existing tax regimes than to compare the existing regime to some ideally neutral system. In evaluating alternative fiscal regimes, therefore, one must consider the effect of alternative tax arrangements on private property rights, incentives to work, save, and invest, and on the allocation of resources in line with consumers' and taxpayers' preferences.

The orthodox theory of optimal taxation presents broadly based taxes as being less distorting (more neutral) than narrowly based taxes designed to raise the same revenue. But this theory suffers from an inability to have an actual lump-sum tax that could be used as a benchmark against which to evaluate alternative tax regimes. More important, the equi-revenue assumption implicitly accepts government as operating in the public interest when, in fact, government may more correctly be viewed as a revenue maximizer. As Brennan and Buchanan (1980) have shown, once government is viewed as a revenue maximizer, the conclusions of optimal tax theory must be

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modified. A public-choice approach then leads one to conclude that broadly based taxes not bounded by the equi-revenue constraint will have a greater excess burden than narrowly based taxes.[17]

Nevertheless, it still holds as a general rule that in raising a *constant* tax revenue, lower marginal tax rates on a comprehensive measure of income or on consumption are preferable to a progressive tax system with numerous loopholes. The present tax system artificially changes the prices of many activities and encourages tax evasion. A simpler, flat tax system would help improve economic efficiency by treating income more uniformly and by allowing resources to be allocated more nearly in line with consumers' and taxpayers' preferences. The danger is that without constitutional limitations on the power to tax, a flat tax with a relatively low initial rate may be increased to its revenue-maximizing level. Under a tax regime with a broadly based flat tax, politicians would have a strong incentive to take advantage of their increased power to tax and the concomitant reduced ability of citizens to escape taxation. In turn, this would increase the excess burden of taxation compared to the present system. Rational taxpayers, therefore, might well prefer a narrower consumption-based tax to a comprehensive, flat-rate income tax.[18]

Certainty and Just Taxation

A tax regime should be characterized by certainty and justice. Certainty can be achieved by a principled approach to tax reform, that is, by constitutional tax reform establishing permanent rules for setting tax rates and for selecting a tax base. Under a constitutional tax regime, tax decisions would be taken out of the day-to-day polit-

[17]According to Brennan and Buchanan (1980, p. 35):

> [O]rthodox normative evaluation of the characteristics of tax structures depends critically on the equi-revenue postulate, one that is untenable when we substitute a revenue-maximizing government for the passively benevolent politics implicitly assumed in the standard treatment. At the constitutional stage of decision in the Leviathan model, potential taxpayers will recognize that government may be held back in its fiscal appetites only by limits on tax bases and on allowable rate structures. Even the analytical benchmark, the idealized and abstract lump-sum tax, loses its "efficiency" features in constitutional perspective.

See Hettich and Winer (1985) for a useful discussion of alternative approaches to tax reform as embodied in the theories of equitable taxation, optimal taxation, and fiscal exchange.

[18]The Brennan-Buchanan (1980) analysis "does not necessarily suggest that the consumption tax will dominate the income tax in the rational constitutional calculus of the potential taxpayer." However, the authors do point out that "restriction of the tax base to consumption outlays will reduce the revenue potential of Leviathan, an objective that may in itself be desirable if the income tax is predicted to generate an overly large sum under revenue maximization" (pp. 107–8).

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ical process and incorporated into the rule of law superstructure that helps shape individual incentives and behavior in a market order. Constitutional tax reform, therefore, would avoid the need for fine-tuning the tax code, which is characteristic of the current tax regime dominated by partisan politics rather than by sound tax principles.

Just taxation requires that the tax regime be in accordance with the principle of voluntary consent: taxes should raise revenue for those public services that taxpayers are willing to finance. Tax policy should not be used to plan the economy and to reward special interest groups. As Andrew Mellon (1924, p. 11) emphasized:

> I have never viewed taxation as a means of rewarding one class of taxpayers or punishing another. If such a point of view ever controls our public policy, the traditions of freedom, justice and equality of opportunity, which are the distinguishing characteristics of our American civilization, will have disappeared and in their place we shall have class legislation with all its attendant evils.

Equity, therefore, requires not only that equally situated individuals be treated equally but that taxes reflect benefits received from public services. Since it is difficult to measure benefits received in a nonmarket setting, it is all the more important to limit government to the provision of those goods (such as the defense of private property rights) whose benefits correlate well with ability to pay. A flat rate tax on consumption or income then could be used to finance the generally accepted level of expenditures.

If taxes attenuate private property rights so that the services received from government are valued less than the alternative private services forgone, or if no services are received for the taxes paid, the tax regime will violate the voluntary consent principle and cannot be justified, at least from the classical liberal's perspective. On the other hand, if one accepts the modern liberal's notion of social or distributive justice, almost any level and distribution of the tax burden can be "justified"—depending on the subjective values of the benevolent despot, the legislators, or the special interest groups who dominate the fiscal process in a democracy.

In choosing between the redistributive state and the minimal state, public choice theory can help indicate the likely consequences of each tax regime for economic incentives and behavior—normative considerations of equity will be influenced by one's perception of the likely consequences of alternative property rights structures. If consumer-taxpayer sovereignty is accepted as the basis for constitutional tax reform, one would expect private property rights to be strengthened. Individuals then would have stronger incentives to

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work, save, and invest compared to the present tax regime in which the power to tax is virtually unlimited.

The Politics of Tax Reform

Since any change in the tax regime will alter the distribution of the tax burden, politicians do not have a very strong incentive to take a principled approach to tax reform. Indeed, tax reform seldom reaches the constitutional stage where serious attention is given to linking government spending to taxes and limiting taxes as a percent of GNP. The pursuit of distributive justice, in other words, has a higher political payoff than the pursuit of consensual justice in the modern democratic/liberal state.

As long as politicians do not bear the full costs of their decisions, the political process will lead them to take a narrow, short-run viewpoint, reducing the likelihood of fundamental tax reform. To be sure, politicians have a strong incentive to hide the costs of government, to increase spending, and to disperse the costs of government while concentrating the benefits. Consequently, real tax burdens are likely to increase over time. As Lee (1983/84, p. 802) notes in this regard:

> There are strong reasons for believing . . . that the democratic process exerts constant pressure toward excessive tax burdens. . . . [T]ax increases are spread widely over a politically unorganized public and can be made to appear largely independent of political decisions . . . while tax proceeds can be directed rather precisely to those coalitions and constituencies that have the greatest political influence. Therefore, the political costs of tax increases will be heavily discounted relative to the political gains from the additional tax revenue. This bias alone exerts tremendous pressure for an excessive tax burden.

Although a relatively low flat rate tax on either income or consumption would be more efficient (in the sense of generating the same revenue at lower cost and with fewer distortions) than the present tax regime, equity considerations (in the sense of social or distributive justice) have come to dominate the 1985 tax debate. According to Rahn (1985): "Nothing less than a national tragedy is unfolding in the House Ways and Means Committee, as its members transmute the laudable goals of tax reform into a complex, anti-growth orgy of redistributive 'justice.' " Authentic tax reform, therefore, has been derailed by special interest groups who want to impose social justice rather than to defend procedural justice. Instead of safeguarding private property rights, these groups would use government to redistribute property to themselves at the expense of other taxpayers.

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When end-state principles of justice are substituted for procedural justice, there can be no hope for consensus on tax reform. It is this lack of consensus that makes tax reform so difficult and that illustrates why meaningful tax reform is impossible without constitutional change. The difficulty, of course, is how to achieve constitutional tax reform in the presence of federal, state, and local legislators who are influenced by special interests. However, without limits on the taxing and spending powers of government, the pursuit of distributive justice is bound to interfere with the goals of simplicity, efficiency, and growth advocated by proponents of tax reform.

The political constraints blocking fundamental tax reform in 1985 or 1986 are formidable. In particular, any reform must achieve (1) revenue neutrality, that is, neither increase nor decrease total federal tax liabilities, and (2) distributive neutrality, that is, not change the distribution of tax burdens by income class. Given the inertia of the federal tax bureaucracy and the entrenched special interests seeking to maintain their tax preferences, these two constraints and the large projected federal deficits imply that political considerations are likely to be the determining factor in shaping tax reform. The principles of sound tax reform—and even constitutional tax reform—will often be referred to by politicians, but they are unlikely to persist in the logrolling process.

The agreement about the need for tax simplification, base-broadening, and lower marginal tax rates to encourage economic growth has been overshadowed by the diversity of opinion about what constitutes a "good" tax system, as illustrated by the number of tax bills now before the 99th Congress. Moreover, the instinct of politicians is to increase their power to tax, not to limit themselves to revenue neutrality. As Lee (1985) observes: "Talk of revenue neutrality notwithstanding, eliminating the escape hatches in the existing tax system appeals to the revenue-enhancing impulses of Congress." If a modified flat tax were enacted, it is likely that tax rates would be increased over time, unless constitutional constraints were placed on taxing and spending. And if rates were increased, the rent-seeking process for tax preferences would begin anew. Citing Lee (1985): "[O]nce rising tax rates increase the profit politicians can realize by merchandizing tax breaks, the 'reformed' tax system will soon be as loaded with loopholes as the present one."

Unless tax reform takes the form of constitutional limitations on the government's taxing and spending powers, therefore, supply-side tax policy aimed at base-broadening and lower marginal tax rates is unlikely to stem the tide of big government. In the longer run, politicians are apt to produce further distortions by increasing

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marginal tax rates and accelerating spending.[19] The excessive taxes of 1985 may then look mild by comparison.

Constitutional Tax Reform

The traditional theory of optimal taxation ignores the public-choice aspects of tax reform. As such, its recommendation for broadly based taxes designed to raise the same revenue as narrowly based taxes is misleading. That is, a move to a flat rate tax will not necessarily increase efficiency if the tax rate is not limited by constitutional law.

The rise of the redistributive state, the focus on the ability to pay principle of taxation rather than on the benefit principle, and the open-endedness of the tax-spending process in a democratic setting have led to the currently chaotic tax code. In this vein, Buchanan (1967, p. 300) has argued that what is needed to stem the tide of government and achieve authentic tax reform is a "constitutional attitude":

> In fiscal theory, as in politics generally, scholars need to pay more attention to the working out of rules or institutions through which final outcomes emerge and less attention to the shape of these outcomes themselves although these must, of course, be relevant to an evaluation of the institutions. Improved allocations, or outcomes, can be achieved only through improvements in the institutions that generate them, and improvements in such institutions, in turn, can be achieved only if their proper role in the whole structure of democratic process is appreciated and understood. Perhaps more than their fellows, scholars themselves need to acquire a "constitutional attitude."

The tax regime, in other words, must be treated as part of the rules of the economic game. The more stable the rules and the more compatible they are with private property rights, the greater will be the incentive to employ resources where they have their highest return to consumers and taxpayers. It is in this light that the late Jan Tumlir (1984, pp. 22–23) called for "constitutional reconstruction" to protect "against the arbitrary exercise of governmental power," and thereby stem the tide of the redistributive state.

In 1985, the legislature's power to tax is still unlimited and the courts continue to defer to the will of the legislative body, even if tax burdens become destructive of private property rights. As Norton (1985, pp. 624–25) points out:

[19]In this regard, Lee (1983/84, p. 810) notes: "Recognizing the need for constitutional reform is an essential first step if such reform is to be successful and if the political post-mortum on supply-side economics is to prove premature."

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> [T]he judiciary will uphold almost any tax classification or unequal placement of tax burdens. The constitutional requirements of uniform and apportioned taxation have been narrowed until they have minimal impact. Furthermore, the fact that a tax is unwisely or destructively high is not grounds for invalidation under current constitutional standards.

Norton calls for a reexamination by the judiciary of the power to tax but concludes (p. 625):

> [E]xisting constitutional doctrines present no easy avenues for the courts to follow in evaluating the constitutionality of taxes. None of the theories discussed . . . may provide sufficient guidance for judicial enforcement. Amending the Constitution to provide more clearly drawn safeguards may ultimately be the only way to guard against abuses of the taxing power.

Norton's conclusion is therefore in accordance with the Buchanan-Tumlir recommendation for constitutional tax reform.

At the heart of constitutional tax reform is the notion brought out by Norton (1985, p. 624), namely: "At some point, tax burdens become so heavy that they begin to undermine the free society they were intended to support. When that occurs, the nation must determine whether the balance between protecting individual rights and ensuring necessary government revenues has been disrupted." Constitutional analysis, therefore, points in the same direction as public choice theory and property rights theory, that is, to the need for changing the tax regime in the direction of limited government. Only then will the goals of tax simplification, consensus about tax shares, efficiency, and justice begin to be achieved.

The recent advances in public choice theory and property rights theory have directed attention to government failure and the benefits of constitutional limitations on the powers of government. Unless the current tax reform encompasses constitutional limits on government spending and taxes, it most likely will follow the route of earlier tax reforms and end up producing numerous new loopholes and adding thousands of pages to the tax code. Authentic tax reform requires that we agree on the appropriate size of government; sound tax principles can then be followed to raise the necessary revenue. Unlike the present fiscal process in which spending decisions are separated from decisions about taxes and in which the government has an unlimited power to tax, a constitutional approach to tax reform would force individuals to consider the true costs of government and, hence, to decide if government is excessive.[20] Tax shares and expen-

[20]Hayek (1984 [1979], pp. 403–4) has argued:

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diture shares can then be modified to conform with taxpayers' sovereignty in the choice of fiscal institutions.

Current Status of the Tax Debate

The papers in this volume develop many of the ideas discussed up to this point. They also provide a useful reference for analyzing the current tax debate. Wagner criticizes the traditional approach to analyzing tax reform on both positive and normative grounds. He argues that the "optimum tax" approach to tax reform ignores public choice theory and operates in an institutional vacuum. The tax reformer/legislator is self-interested and operates within a common property framework, thus one must begin any positive analysis of tax reform within the given institutional arrangement rather than compare the current regime with some ideally neutral system. If tax reform does not change the existing institutional-incentive structure in which government officials have an unlimited power to tax and an incentive to maximize revenue, moving to a flat tax regime is unlikely to produce results that compare favorably with the current regime.

From a normative viewpoint, Wagner shows that traditional tax theory has taken an end-state approach to justice and used the ability to pay principle to "justify" the redistributive state. As such, those who adopt the traditional normative theory of tax reform act as if tax reform can be considered apart from the subjective interests of taxpayers. The benevolent despot (qua tax reformer/legislator) is then placed above individual property rights and the consensus of fiscal exchange is replaced by the arbitrary force of legislators acting in the

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Nothing would probably provide a more salutary discipline of expenditure than such a condition in which everybody voting for a particular outlay would know that the costs would have to be borne by him and his constituents in accordance with a predetermined rule which he could not alter. . . . It is probable that the whole complexity of the tax structure we have built up is largely the result of the efforts to persuade citizens to give the government more than they would knowingly consent to do. . . . [N]othing short of . . . a complete reconsideration of the institutional setting of financial legislation can probably stop that trend towards a continuing and progressive rise of that share of the income of society which is controlled by government.

According to Hayek (1960, p. 323):

The most reasonable rule . . . would seem to be one that fixed the maximum admissible (marginal) rate of direct taxation at that percentage of the total national income which the government takes in taxation. . . . Adherence to this principle would have the salutary consequence that every budget would have to be prefaced by an estimate of the share of national income which the government proposed to take as taxes.

Compare Wicksell (1964 [1896], pp. 87–97).

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"public interest." Wagner suggests abandoning the public interest model in favor of Wicksell's contractarian model, in which tax decisions are linked to expenditure decisions and the fiscal regime is judged on the basis of its conformity with the principle of voluntary consent. In this model, therefore, the emphasis is placed on the marginal benefit principle of taxation and the safeguarding of private property rights. While reconsidering the normative theory of taxation, Wagner reminds us that a sound, positive theory of public choice can help guide our choice of the fiscal regime by deriving the implications of our normative predispositions. Public choice theory warns us to be wary of self-interested public officials seeking to do good with other people's money.

McCaleb also takes a positive, public-choice approach to analyzing the current tax reform proposals and reaches conclusions about the efficiency of the current tax regime that are similar to Wagner's. In examining the efficiency of the current system, McCaleb discusses three public choice models: the private exchange model, the fiscal exchange model, and the Leviathan model. From his analysis, he concludes that the present tax system may be more efficient than moving to a flat tax regime where the power to tax is still unchecked. Like Wagner, therefore, McCaleb basically agrees with the Brennan-Buchanan argument that a flat tax by itself is not sufficient to improve the situation of individual taxpayers or to stop future rent-seeking. Instead, the flat tax must be combined with constitutional limitations on the government's taxing and spending powers if meaningful tax reform is to occur.

Gwartney and Long, Reynolds, and Vedder all accept the supply-side arguments for tax reform. Gwartney and Long review the history of the U.S. federal income tax and reexamine the arguments for a progressive income tax. They argue that the progressive tax has decreased economic efficiency and increased tax avoidance. Thus, switching to a flat rate tax (or a modified flat rate tax) would stimulate economic growth, just as occurred during earlier tax reforms when marginal tax rates were significantly lowered. Reynolds draws on the experience of other countries to provide abundant evidence of the success of supply-side tax policy. He illustrates that countries with lower marginal tax rates on individual income have experienced higher real growth rates than countries with relatively higher tax rates. Consequently, low-tax countries typically experience faster growth in real tax receipts relative to high-tax countries. Vedder draws a similar lesson from his comparison of high-tax and low-tax states. Using regression analysis, he finds a statistically significant

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(positive) relationship between the flatness of a state's income tax rate and the growth of its real per capita income.

Minarik's paper points to the confusion surrounding the use of the terms "flat rate tax" and "tax reform." Almost all of the flat tax proposals are for modified flat rate taxes that exhibit some progressivity. Moreover, there is little consensus about the shape actual tax reform should take, except that it should promote "fairness," that is, "treat all tax payers in roughly the same way." According to Minarik, supply-siders have exaggerated the beneficial effects of lowering marginal income tax rates. Thus, he is concerned about the distributional impact flat tax reform might have on lower- and middle-income households and its effect on the deficit.

The papers by Gephardt, Kemp, and Johnson provide a detailed analysis of the three major tax reform proposals: the Bradley-Gephardt proposal for a "Fair Tax"; the Kemp-Kasten proposal for a "Fair and Simple Tax"; and President Reagan's proposal for a modified flat tax, Treasury II. The papers by Gephardt and Kemp also present an interesting discussion of the politics of the current tax reform movement, especially the rent-seeking that accompanies changes in the tax code. All three of these papers agree that what is needed is a supply-side tax policy that will simplify the tax code, broaden the tax base, reduce marginal tax rates, stimulate economic growth, and lead to a more equitable tax system.

The papers by Hall and Rabushka, and Canterbery, Cook, and Schmitt offer additional proposals for tax reform. Hall and Rabushka propose a flat rate tax on consumption, which would be progressive at lower- and middle-income levels by including a sizeable exemption. They argue that a consumption-based tax would be superior to the present income tax because it would encourage saving and investment and increase economic growth. Canterbery, Cook, and Schmitt prefer a combination of a modified flat tax, a negative income tax, and a consumption-style VAT, which they call FLANVAT.

Dye examines the impact of federal tax reform on state and local finances. He analyzes the arguments for deductibility of state and local taxes from federal tax liabilities and for the favorable tax treatment of state and local government bonds. According to Dye, it would be advisable to eliminate state-local tax deductibility and the tax exemption for private-purpose municipal bonds, even if there were no comprehensive tax reform.

In the final paper, Browning and Browning argue that a *true* flat rate tax would increase economic efficiency and stimulate economic growth. These efficiency gains could then be used to help offset any adverse distributional effects the flat tax regime has on lower income

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households. Indeed, the authors think that the long-run efficiency gains from a low, flat rate tax could more than offset any adverse, short-run distributional effects. As such, moving to a true flat rate tax actually could benefit lower income families. The equity arguments directed against a true flat rate tax, therefore, are misplaced. Browning and Browning also point out that even though the *modified* flat tax will decrease statutory tax rates, it will not change effective rates. Hence, it is incorrect to expect any significant effects on labor supply, saving, or investment under the three major tax reform proposals, all of which seek to maintain revenue neutrality and a constant tax liability by income class.

The present tax reform debate no doubt will continue beyond 1985, for tax reform in a democracy is an ongoing process. Whether the rent-seeking nature of this process will be changed by replacing the current tax regime with a set of fiscal institutions that limit the government's taxing and spending powers will depend on whether the public understands the importance of constitutional tax reform.

Supply-side tax policy and constitutional tax reform would provide a stable institutional framework for individuals to pursue their own goals without the threat of excessive tax burdens and without the uncertainty of the social engineering that now occurs under the tax code. Constitutional tax reform, therefore, would improve the coordination function of the market price and profit system and encourage economic growth.

The merging of supply-side economics and constitutional tax reform will be slow in coming. Much research still has to be done concerning ways of implementing and maintaining a constitutional tax regime. A return to the "constitutional attitude," however, is a necessary step toward a sounder fiscal regime—one that protects property rights and does not subject individuals to the chaos of a tax-distorted economy.

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NORMATIVE AND POSITIVE FOUNDATIONS OF TAX REFORM

Richard E. Wagner

Many of the papers in this volume examine flat rate taxation as an alternative to the federal government's existing system of income taxation. My concern, however, is with some of the normative and positive foundations that must underpin *any* consideration of tax reform. Normatively, it is necessary to have a vision of what constitutes a good tax system, for otherwise there is no basis for claiming that flat rate taxation or any other proposed change truly represents a reform. But it is not sufficient simply to show that the actual system deviates from the ideal, however this ideal is defined. It is also necessary to show that the proposed reform will *truly* represent an improvement, as assessed against the postulated norm. This latter task is one of positive analysis that entails predictions about the consequences of the proposed reform, predictions that in turn require an understanding not just of economic phenomena, but of political phenomena as well.

In this essay, I seek briefly to reconsider the economic analysis of tax reform in general, and flat rate taxation in particular, with respect to both normative and positive foundations. In doing this, I am more interested in exploring what might be called the grammar of tax reform discussion than in trying to support or oppose flat rate taxation per se. I have two main theses to advance, one normative and one positive. The normative thesis is that almost all such discussion confounds two incompatible principles of evaluation. The positive thesis is that most tax reform analysis is deficient because it fails to treat collective choices as endogenous, and therefore misrepresents the probable consequences of proposed tax reforms.[1]

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[1]For a careful survey of what they characterize as the "equitable taxation," "optimal taxation," and "fiscal exchange" approaches to the analysis of tax reform, see Hettich and Winer (1985).

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Normative Principles for Tax Analysis

In discussions of flat rate taxation, or of any other proposal for tax reform, it is common to support or oppose the proposal with reference to predictions about its probable impact on such things as saving and capital formation, patterns of investment, and the distribution of income. One person might argue for flat rate taxation on the ground that it will reduce the welfare loss from distortions in patterns of investment that arise because there are different marginal tax rates attached to different types of investment. Someone else might argue against flat rate taxation on the ground that it will shift tax liability from those with relatively high incomes to those with relatively low incomes.

The various dimensions against which proposed tax reforms are assessed are commonly collapsed into two: efficiency and equity.[2] From this point of departure, it is but a short step to conceptualize some trade-off between equity and efficiency, in which principles of efficiency are abridged or amended by principles of equity or justice. In earlier literature, this principle of equity was expressed by two ideas: (1) the taxes that government collects should be related to some notion of ability to pay and (2) equally situated people should pay equal taxes. The more recent literature on optimal taxation operates from within the same utilitarian framework, and solution of the problem of optimal taxation becomes, metaphorically speaking, a problem of how equally to slice a pie when the size of the pie varies inversely with the equality of the slices. For instance, under an assumption of identical income-utility schedules with diminishing marginal utility, in conjunction with an assumption of zero-elastic factor supplies, optimal taxation is that which promotes full income equality. This is true with even what is referred to in this literature as the "individualistic" norm, that is, the Benthamite social welfare function, in which the maximand is the sum of the utilities of the individuals who constitute the nation.

Yet it is surely a curious piece of vocabulary that affixes the designation "individualistic" to an analytical construction in which people are manipulated as objects at the disposal of some type of despot, who is presumed to be benevolent by virtue of being named "Social Welfare Function." It is an equally curious piece of vocabulary that speaks of a trade-off between efficiency and equity, for to speak of such a trade-off is to confound two contradictory norms regarding the proper relation between citizen and state. Efficiency, as expressed

[2]See the discussion in Musgrave (1959, pp. 61–115), along with the further development in Atkinson and Stiglitz (1980, pp. 333–65).

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in its benefit principle incarnation, is a derivation from the general normative vision expressed by contract theories of the state. The fundamental axiom of the benefit principle is one of individual self-ownership: people and their rights are treated as normatively prior to government. Efficiency is defined by consensual action within the framework of those prior rights of person and property, and is not something that can be assessed with reference to some objective, external criterion. Efficiency, in other words, represents an *immanent* standard of evaluation.

In contrast, in both the older discussions of ability to pay and in the newer discussions of optimal taxation, the fundamental axiom is one of collective ownership of individuals. Government is prior to people and their rights of person and property, and evaluation proceeds according to some external or *transcendent* criterion of goodness: public outcomes are evaluated in terms of some transcendent criterion that expressly denies the normative status of consent. Individual rights either represent grants from government or reflect the inability of government fully to control its own domain. A tax system is judged good not because it allows people to further their common interests, as judged by consent among them, but because it accomplishes particular, externally imposed objectives. Again, the so-called individualistic norm represented by the Benthamite social welfare function is transcendental and not immanent: it expresses external authority over people rather than allowing people to work out their own arrangements within the framework of the rules of property and contract.

One can, of course, adopt whatever set of normative axioms one chooses. The axiom of individual self-ownership, along with its corequisite immanent approach to evaluation, is surely more consistent with a democratic polity within a liberal society than is the axiom of collective ownership of individuals, with its corequisite transcendent approach to evaluation. Moreover, and regardless of how one might assess this question of normative perspective, it is still impossible to assess proposals for tax reform without a theory of public choice, as I shall try to explain later in this essay.[3]

All transcendent norms are, of course, despotic, in that they represent authority over people. Some of these are benevolently or

[3]While one might normatively adopt Lockean norms of individual self-ownership, a growing body of literature on public choice suggests that the Hobbesian vision might be more congruent with positive analysis. See Ostrom (1984) for a comparison of these alternative visions. Ostrom seems perhaps to be more optimistic about Locke's approach to incentive compatibility than much of the public choice literature might seem to suggest is warranted.

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paternalistically so, while others are more fearsome. But in terms of central principle, there is little difference between contemporary norms of equity and optimal taxation and, say, Machiavellian-like norms for the guidance of actual rulers. Indeed, much of the theory of fiscal illusion that developed in Italian scholarship construed the problem of fiscal conduct as one of how a ruling despot could use his position to maximize his wealth.[4] Even much earlier in Italy the same frame of reference could be found. Suetonius (1957, p. 126), for instance, reports that a relatively early expression of such a guiding principle was articulated by the Emperor Tiberius, who replied to some of his governors who wanted him to impose higher taxes: "A good shepherd should sheer his flock, not skin it."

As various forms of constitutional monarchies, republics, and democracies emerged in Europe, real despots disappeared, and norms now came to be directed to some fictional person who often was named "Public Interest." In the last years of the 19th century, Knut Wicksell (1958, p. 82), in a book on the legal, economic, and political aspects of government, noted that, in criticizing the then standard approach to public finance, and which is still the standard approach: ". . . the whole theory [of public finance] still rests on the now outdated political philosophy of absolutism. The theory seems to have retained the assumptions of its infancy, in the seventeenth and eighteenth centuries, when absolute power ruled almost all Europe."

Sometimes the continuation of this approach under non-absolutist regimes was justified by adopting the fiction of the benevolent despot. With this civilizing of the despot, assessments of policy options became pronouncements about what a benevolent despot should do. As in the age of absolutism, standards for assessing policy outcomes were still grounded in some alternative principle to that of a consensus among the participants. Outcomes were still assessed against some externally imposed criterion of doing good, only "good" was no longer assessed by some actual ruler, but rather was assessed by some fictive and benevolent despot, who was presumed to be guided by some such idea as minimizing the sacrifices that taxes impose on people, or of using the budget to maximize the utilities that the members of a nation get from their incomes. Regardless of the details of the historical development of this literature, or of the contemporary scholarship in what has come to be called the theory of optimal taxation, the central point remains the same: policy outcomes are assessed against some transcendent criterion of goodness, indepen-

[4]See Buchanan (1960) for a discussion of the work of Italian economists during the late 19th and early 20th centuries.

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dent of any consideration of what the participants might or might not work out among themselves, in light of their preexisting rights of person and contract.

By contrast, the contractarian perspective, which follows from the Lockean norm of individual self-ownership, takes an immanent approach to evaluation. People and their rights of person and property are prior to government, and the task of government is to support people in their efforts in those cases where people can do better for themselves through common action than they can do through individual action. "Better," however, is determined by those individuals themselves, so the standard of evaluation for policy outcomes must ultimately be a standard of consent among the participants. And this is genuine consent and not the tautological version in which the mere presence of what are called "democratic" institutions is taken to mean that those institutions necessarily reflect such consent. Legislative actions may reflect such consent and hence be legitimate, but they also might not. The victim who yields her purse and her body to the knife-yielding intruder "consents" to do so in light of the alternative, just as citizens "consent" to be taxed, regulated, and otherwise governed in light of the alternative. But it is possible to move beyond a statement of tautology only by recognizing that contractarian principles are the only principles that are appropriate for a society of free people. In such a society, people have their various rights of person and property, and government must itself operate within the same general principles as all other participants in society; government's actions are to fall within the constraints offered by the previously existing rights of property and contract, a requirement that is the central principle of what is called the rule of law.[5]

Within the contractarian perspective, the question of what makes for a good or bad tax system cannot be answered independently of the interests of the people who constitute the government. There is no possibility of determining a "good" tax system independently of a consideration of the interests and values of the people who constitute the polity under consideration. When people and their rights come first, normatively speaking, tax systems cannot be supported in terms of their impact on any such variables as economic growth or income distribution per se, but can only be supported in accordance with their ability to support and promote the interests of the people who constitute the polity in question. An argument that a tax reform increases (or lessens) progressivity might be pertinent information

[5]The most complete and recent exposition of this Lockean perspective is Nozick (1974). For an explicit extension of that perspective to taxation, see Mack (forthcoming).

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in trying to assess tax reform proposals, but it is not itself a standard of assessment. Similarly, an argument that a reform will increase (or decrease) saving and economic growth might inform personal judgments, but that particular consequence is not a standard of evaluation. The standard of evaluation in the contractarian framework is one of consent.[6]

Positive Analysis and Normative Principles

Any effort at normative assessment or formulation raises in turn the positive question of incentive compatibility: any norm requires an institutional order that is consistent with its own promotion. However, the presence or absence of such consistency is itself a positive and not a normative matter. While I think the normative element in most tax analysis is deficient in that its foundation seems more suitable for some despotic or paternalistic regime than for a democratic regime, I also think the positive element is deficient, regardless of normative perspective. Tax reform discussions tend *not* to be informed by an understanding of the operation of political institutions, but without such an understanding grounded in *political economy,* it is impossible to assess the properties of proposed tax reforms, regardless of the normative standards of assessment.

Even if the question of appropriate norm has been settled, the assessment of options for tax reform cannot be conducted without a theory of public choice. The base-broadening and rate-lowering capabilities of flat rate taxation have been supported by various arguments concerning equity and efficiency. However, whether the attainment of those ends will be promoted or impeded by the proposed reform requires some modeling of economic and political phenomena, that is, it requires a theory of public choice. To illustrate this proposition, I shall consider the common usage of concepts of equity and efficiency to assess tax systems and proposals for tax reform. In doing so, I should want to make it clear that I am not espousing such normative usages, because they are predominately transcendent in their orientation. Rather, I am merely interested in illustrating some of the problematical features that arise from failing to address normative propositions in light of positive models of political economy.

Equity, Capitalization, and Tax Simplification

Equity concerns relating to tax simplification are usually formulated in terms of equally situated people having different tax liabil-

[6]This thesis has been explored by Buchanan in several places, including (1959, 1976, and 1977).

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ities. Two people might each have $10,000 of interest income, but one person's source is tax-exempt municipal bonds while the other person's source is taxable corporate bonds. Both have the same interest income, but are taxed differently, so the holder of the tax-exempt bonds has a higher post-tax income. Alternatively, someone who buys a house is able to deduct interest on the mortgage, but someone who rents is not. Relatedly, the homeowner is not taxed on the rental value of his house, but the landlord is. Hence, the homeowner is favored relative to the renter, and homeownership is favored relative to tenancy. Numerous similar illustrations could be given; the literature on what has come to be called tax-expenditure budgeting is filled with such illustrations. It would seem as though ordinary canons of equity are violated repeatedly through a prolix variety of loopholes and exclusions in the tax system. If so, tax simplification, as through flat rate taxation, would seem to be a strong force for equity, defined as the equal taxation of equally situated people.

However, the claims of inequity cannot be advanced on the basis of such arithmetic reasoning, for to do so involves a presumption that relative factor supplies are invariant to net returns. Once it is recognized that factor supplies vary directly with net returns, claims of inequity largely vanish, and if anything would be a source of inequity it would be reforms that simplified the tax system, as Goetz (1978), among others, has explained. The holder of tax-exempt bonds receives a lower rate of interest than the holder of taxable bonds; the higher price the holder of tax-exempt bonds pays is roughly equivalent to the alleged tax advantage: this equivalence is an inherent feature of a market economy. The renter has no mortgage interest to deduct, but competition among owners for tenants means that the owner's ability to deduct mortgage interest results in lower rental payments roughly equal to the amount of the tax deduction. And in all similar illustrations of the inequitable features of what commonly are called "loopholes," the same point can be made: so-called tax advantages do not confer gains on the nominal recipients.

All such gains are realized at the time the programs are announced (or actually anticipated). Starting from a regime in which all interest income is taxable, the conferral of a tax exempt status on municipal bonds would give an advantage to those who hold bonds when tax exemption is initiated (or rather, when its initiation is anticipated), just as the elimination of such a status would place a penalty on the present holders. But as a result of the creation of this tax-exempt status, the demand for the bonds will increase, thereby increasing the price and lowering the yield, and doing so sufficiently to eliminate the differential advantage from holding the bonds. Subsequent

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holders of tax-exempt bonds gain no advantage. Flat rate taxation, then, would not redress inequities, but rather would create them: it would impose a capital loss on the holder of tax-exempt bonds and confer a capital gain on the holder of taxable bonds. And it would be the same for any such base-broadening, "loophole"-closing "reform." Moreover, the extent of inequity from such a reform would almost surely rise with the length of time the provision in question had been in force. The most equitable tax reform, in other words, would seem to be no-reform, at least when equity is defined as the equal treatment of equals.

Efficiency, Tax Reform, and Public Choice

As for efficiency, it is commonly claimed that the differential tax treatments that pervade the present income tax system create various economic distortions, the significance of which can be assessed with the welfare-cost methodology developed by Harberger (1964). Even if it is acknowledged that the deductibility of mortgage interest is not a source of inequity, it alters the composition of the capital stock in the direction of more residential capital and less nonresidential capital. Hence, tax simplification would be efficiency-enhancing, because it would induce a reallocation of capital away from uses with relatively low pre-tax returns to uses with relatively high pre-tax returns. However, even if flat rate taxation were presumed to offer this gain in efficiency, the case for flat rate taxation would not be made ipso facto, because that efficiency would have been attained at the expense of inequity, through the imposition of capital gains and losses among otherwise equally situated people. Even if this argument about efficiency were accepted, it would have to be accompanied by some complementary argument to the effect that the efficiency gains were more valuable (to whom?) than the equity losses.

But there is more than this consideration of trade-off with which to question the standard analysis of efficiency. A long tradition of economic analysis notwithstanding, analysis of the efficiency consequences of flat rate taxation, or of any other proposed reform for that matter, is incomprehensible without some theory of public choice. The Harbergarian methodology adopts some market standard as a norm, and treats such things as the deductibility-induced expansion in housing as a sign of inefficient investment. If this were so, flat rate taxation would be efficiency-enhancing. But how can this determination be made? It is an easy task to model homeownership as a source of external economies, perhaps supported by arguments to the effect that a society of homeowners has more desirable characteristics than a society of tenants. In this alternative formulation,

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mortgage deductibility is one possible means of internalizing some of the external benefits from homeownership. In this case, the expansion in homeownership that results from deductibility would not be counted as a cost, as it is in the Harbergarian methodology, but rather would be counted as a social benefit. Moreover, a prolix variety of so-called loopholes and privileges can be rationalized by such reasoning, as Thompson (1974) has shown so ingeniously in a different setting.

Alternatively, someone might argue that deductibility is a way of transferring wealth from taxpayers generally to various specialized inputs engaged in the production of housing services. So long as those inputs are specialized, an expansion in demand will create rents for the inframarginal inputs. Whether such specialization might exist, where it might exist, and for how long it might exist, are empirical questions, of course, but in any event such a measure might have political survival value, as the growing literature on rent seeking has come increasingly to explore.[7]

Models similar to those explored in the literature on rent seeking also suggest that such base broadening as that envisioned by flat rate taxation would be a means of increasing the overall level of taxation. Suppose Brennan and Buchanan (1980) are correct, at least as a first-order approximation, that government can be viewed as a revenue-maximizing entity. If so, it would exploit each tax base to its point of unitary elasticity. For a given structure of tax bases there would be a set of rates applied to those bases that would maximize government's tax take. Although proponents of flat rate taxation typically speak of reducing rates so as to offset the revenue-raising impact of the broadened base, the Brennan-Buchanan perspective would suggest that whatever rate reduction might take place would be less than the extra revenues generated by the broadened tax base. Flat rate taxation, at least of the base broadening sort that informs current discussion, would, according to these types of models, most certainly not represent mere tax simplification, but would represent an increase in the total tax take by government.

What this all means is that flat rate taxation, or any proposed tax revision, cannot be evaluated without a model of *political economy*. Moreover, this raises some conundrums. In a model of what might be called "perfect polity," "loopholes" are not signs of either inequity or inefficiency, but rather are signs of the political correction of market failures. In such a model, flat rate taxation would not offer the improvements its advocates claim. Use of the Harbergarian

[7]See the survey article by Tollison (1982).

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methodology would be inappropriate in such a setting. But in a model of "imperfect polity," flat rate taxation may well offer the improvements its advocates claim. However, the Brennan-Buchanan considerations would also become relevant, as would other, related considerations from the theory of public choice, considerations that are summarized by Aranson and Ordeshook's (1977) model of the "failure of representative democracy." Among other things, flat rate taxation becomes a vehicle for raising overall tax burdens.

Knut Wicksell and the Contractarian Perspective

Knut Wicksell (1958) published probably the most important work to date on the concrete implementation of principles of consensual governance that is central to the contractarian perspective on taxation and tax reform. Wicksell's normative point of departure was an acceptance of the contractarian principle, and he went on to show how this principle could be used to construct particular institutional rules for a concrete historical situation.[8] Wicksell sought to describe institutions that would promote what might be called consensual or concordant, as against factional or majoritarian democracy, and to do so within the Swedish context of his time. In that context, Sweden was a constitutional monarchy, so the two main institutions with which Wicksell was concerned were the Crown and Parliament. The Crown, like any executive agency, Wicksell thought, would be generally interested in expanding its operations—but it could do so only by receiving larger appropriations from Parliament. And as Wicksell recognized, should Parliament act by majority rule, government would become excessively large as evaluated by the principle of consent of the governed. This would occur because of the ability of winning majorities to impose costs on losing minorities, a phenomenon that has been reemphasized by recent scholarship in public choice.

But Wicksell also saw Swedish society as essentially consisting of a relatively small number of relatively homogeneous groups. This feature of Swedish society meant, Wicksell thought, that it would be possible to organize the Parliament in such a way as to give proportional representation to those various groups. With different parties representing the different groups, a system of proportional representation would bring about a fairly complete representation of Swedish society, and would do so in a Parliament that contained a comparatively small number of relatively homogeneous parties. From here,

[8]See Hennipman (1982) for a consideration of the common foundations of Wicksell's formulation and the Pareto principle.

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the rest of Wicksell's approach follows straightforwardly. To implement a principle of consensual or concordant democracy and to prevent the violence of factional or majoritarian democracy, Wicksell proposed to allow each party in Parliament to withhold the tax payments that would otherwise be due from its constituents, if it did not think they were getting adequate value in return for their taxes. It is this feature of Wicksell's proposal that is referred to as a rule of near-unanimity. Wicksell proposed that taxing-and-spending choices require substantial consensus, on the order of 75 to 90 percent among the parliamentary representatives. This type of near-unanimity among the representatives of a comparatively small number of relatively homogeneous groups within a Parliament selected by proportional representation is not, of course, anything like merely applying a rule of near-unanimity to the existing Congress in contemporary America.

Wicksell took a general principle that government should reflect the consent of the governed and developed some particular institutional implications of that principle as he thought these would apply to Sweden in 1896. He suggested one particular constitutional regime that was consistent both with a contractarian framework and with the Swedish institutions of his time. Wicksell's work addressed the interdependence between normative presuppositions and positive analysis of political economy: he addressed forthrightly the problem of incentive compatibility. Starting from a general normative premise of classical liberalism, Wicksell recognized that the institutional or constitutional framework within which government governs can be either subversive or supportive of that normative premise. He recognized, as modern scholarship in public choice and political economy has continued to explore, that a constitutional order grounded in parliamentary majorities was inconsistent with the liberal or consensual value premise. Wicksell further recognized that for consistency to result between norms and outcomes, it was necessary that the pattern of incentives that a particular constitutional regime presents to people must be compatible with the consensual principle. And even putting Wicksell's affirmation of liberal-contractarian values aside, what remains is a recognition that it is impossible to assess any proposal for tax reform without invoking some theory of public choice, for otherwise there will be no cognitive basis for claiming that the proposed reform truly promotes the norm that serves as its justification.[9]

[9]For a more extensive consideration of taxation and tax reform from within a Wicksellian public choice perspective, see Wagner (1985).

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Tax Institutions and Fiscal Exchange in a Contractarian Paradigm

Within a contractarian framework, tax systems cannot be judged independently of choices concerning public expenditure. In the Wicksellian version of that framework, there are no independently existing tax institutions in the first place, save those that would be used to discharge prior obligations. Each expenditure proposal would be coupled with a proposal to cover the cost; there would be no tax institutions that would be permanently in place to gather revenue, save again for the financing of such prior obligations of that represented by public debt. The Wicksellian framework emphasizes the choice of political institutions; he described a set of political institutions that if enacted would give budgetary outcomes that could be described by the familiar Lindahl (1958) diagrammatics. Lindahl's diagrammatics, in other words, would be an apt representation of a regime that operated according to the set of political institutions that Wicksell described.

Modern revenue systems, however, are characterized by tax systems that are in place and which generate revenue independent of expenditure choices. And under some circumstances such an independently existing tax system can substitute for a more restrictive political system. In the more general contractarian framework, there is a trade-off between political and fiscal institutions.[10] Successful exploitation of this trade-off would enable a less restrictive voting rule to be used without affecting the veracity of the Lindahl-like description of outcomes. For instance, and as one example, if public spending could be limited to items of broad or common interest, and if, moreover, income and price elasticities of demand were unitary, a proportional income tax would produce the Wicksell-Lindahl outcome regardless of the voting rule—unanimity, majority rule, or an any-person rule would give the same outcome. This particular result comes about, of course, because it is simply assumed that governmental services are of universal benefit, as described by the postulated elasticity conditions. Under alternative assumptions, the particular voting rule can make a great difference.

In any event, within the contractarian framework tax institutions are seen from two perspectives. On the one hand, they are "prices" that people pay for governmental output. Within the Wicksell-Lindahl framework, taxes in the public sector are essentially indistinguishable from prices in the private sector. On the other hand, taxes

[10]This is developed in Buchanan (1967).

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are also constraints on political outcomes. Political outcomes, like market outcomes, reflect the pursuit of personal interest within a particular institutional regime that establishes a pattern of costs and gains to various actions. For instance, a rule of generality in taxation precludes majority coalitions from shifting tax burdens onto the remainder of society. If everyone is liable for taxes, the members of a winning majority must pay as well as the members of the minority. As tax bases become more specific or less general, the scope for such tax discrimination is broadened.

Furthermore, once tax institutions are looked upon as constitutional, constraining rules, it is clear that it is important that they be predictable. They are part of a system of law or rules; they form part of the framework people take into account in undertaking their various economic activities. As a result tax changes should take place rarely and not regularly, and probably should rarely if ever take place contemporaneously, let alone in ex post fashion as tax legislation often does. One of the fundamental lessons of economics concerns the importance of institutional stability in creating a climate that produces the stability of expectations that encourages people to make long-term investment choices. The annual flood of tax legislation that has become characteristic of the past two decades, however, is surely itself a significant source of uncertainty, for it reduces the assuredness with which people can reasonably hold beliefs about the productivity of future investments.

Conclusion

The main point of this essay has been more one of suggesting a different way of thinking about matters of taxation and tax reform than to support any particular reform, either one version of flat rate taxation or another, or something else entirely. The common approach to tax analysis is, as I have tried to explain, deficient on both normative and positive grounds.

Normatively, the conventional grammar of tax analysis is despotic and not democratic in its orientation. Tax systems are assessed in terms of how far they advance a particular assessor's view of what he or she would like to see accomplished, whether it would be faster growth, less homeownership, greater equality, more investment in research and development activities, or whatever else one might choose to plead a case for. However, a thoroughgoing acceptance of the liberal norms that inform the rhetoric if not the practice of the American commonwealth requires a different grammar for tax analysis and evaluation: what might be called a Wicksell-Lindahl type

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of grammar rather than an Edgeworth type of grammar. Tax systems are not to be evaluated in terms of their ability to foster particular substantive goals that the analyst favors, but rather are to be evaluated in terms of their ability to reflect and be consistent with a consensus among the participants, in light of those participants' prior rights of person and property.

On positive matters, political outcomes are as much a reflection of the interaction of people pursuing their interests as are market outcomes. Once this is recognized, the constraining impact of different tax institutions comes to occupy a central position in tax analysis. Given a particular set of political institutions, tax institutions can be assessed in terms of their ability both (1) to reflect more fully people's willingness to pay for public output and (2) to preclude gross violations to the contrary. Taking seriously the dictum that government should reflect the consent of the governed, the choice between flat rate taxation, in one form or another, and the present system may well be of relatively little consequence. There is some basis for thinking that flat rate taxation would increase overall tax burdens. There is also some basis for thinking that the simplification that flat rate taxation *might* (though I doubt in actuality) produce would generate some social saving, both in terms of tax administration and in terms of Harbergarian losses. But regardless of the Harbergarian triangles, flat rate taxation would do nothing to address the Tullockian, rent-seeking rectangles. Flat rate taxation seems to offer no inducement or incentive for government more fully to reflect the consent of the governed. Nor does it seem to offer any penalty for government to control its excesses in the opposing direction.

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THE RHETORIC AND REALITY OF TAX REFORM

Thomas J. DiLorenzo

Richard Wagner (1985) has done an excellent job of cutting through much of the rhetoric and pretense that surrounds the issue of tax reform. The standard public finance analysis of taxation is pretentious because it purports to explain the implications of alternative tax regimes for "social welfare," as though social welfare is something that can be defined by social scientists apart from the opinions of members of society. Benefits and costs are subjective, and interpersonal utility comparisons are impossible, so that economists who employ the social welfare function in their analysis really have nothing to say about social welfare. One can argue in favor of one tax system over another on grounds that it may stimulate savings, capital accumulation, and so on, but that is different from saying it would enhance social welfare, a necessarily subjective phenomenon.

The labels "efficiency" and "equity" are, in my view, excuses that economists sometimes use for their support of coercive governmental policies. As Professor Wagner clearly shows, any change in the current tax system will impose transitional losses on some individuals and grant transitional gains to others. To call such a change "efficient" is misleading, at best, since efficiency, as Professor Wagner notes, is best defined by consensual action "within the framework of those prior rights of person and property, and is not something that can be assessed with reference to some objective, external criterion" (p. 387). Economists' standard definition of efficiency ignores the principle of self-ownership: the notion that people and their rights are seen as prior to government. By ignoring or denying these rights some economists engage in intellectual exercises, says Wagner, "in which people are manipulated as objects at the disposal of some type of despot, who is presumed to be benevolent by virtue of being named 'Social

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Welfare Function' " (p. 386). It is incredible that the "optimal taxation" literature designates this collectivist notion as "individualistic." But despite this mislabeling, the economics literature embodies a collectivist view of property ownership: Individual rights represent grants from government so that arbitrarily rearranging or abolishing some of these rights is said to be the "legitimate" domain of government. For instance, academics and policymakers often plead for changes in the tax system that would unequivocally hurt some individuals, all in the name of promoting efficiency or equity as defined by the academics and policymakers. The rhetoric of efficiency and equity is all too often used to "justify" governmental policies that violate the rights of political minorities.

Another theme of Professor Wagner's paper is that "[f]lat rate taxation seems to offer no inducement or incentive for government more fully to reflect the consent of the governed. Nor does it seem to offer any penalty for government to control its excesses in the opposing direction" (p. 398). In fact, if my suspicions are correct, the current proposals for flat rate taxation would probably induce government to further *ignore* the consent of the governed. My suspicions, which Professor Wagner seems to agree with, are that a flat tax will mean a higher overall level of taxation. It is inconceivable that federal politicians would construct a tax reform that would leave themselves with *less* tax revenue. Moreover, the claims of how the current proposals are "revenue neutral," that is, they would leave total tax revenues unchanged, are nonsense. No one can accurately forecast the economic effects of such tax changes and the consequent changes in government tax revenues. In fact, the so-called government forecasts produced by the Treasury Department and the Congressional Budget Office assume there are *no* economic side effects of such changes in the tax system. These analyses are completely static and are therefore useless. Is there anyone who takes such government (or private) economic forecasts seriously? Given the great uncertainties involved, and the fact that no one knows what these "revenue forecasts" mean, it is quite likely that any tax reform that is consummated will "err" on the side of *increasing* taxes. If so, this latest tax reform, like most others in recent memory, will not be a true reform but simply a tax increase. And to those of us who believe that Congress is truly out of control and largely unresponsive to the wishes and consent of the governed, another tax increase would only encourage Congress to continue its fiscally irresponsible ways.[1]

[1]James T. Bennett and Thomas J. DiLorenzo (1983, 1985) discuss how government has become progressively less democratic and more authoritarian over the past several decades.

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Runaway government spending is the real problem, but the current tax reform proposals do not even address that issue. If one values rights to person and property, then it is important to realize that government spending continues to be a gross violation of those rights. The essence of taxation is to coerce one group of citizens to give up some of their property so that others may benefit. If ever there was a definition of legalized theft, this must be it. Furthermore, the true measure of "taxation" is not tax revenues *per se*, but government spending (Friedman 1978). The true "cost" of government is better represented by the level of spending than explicit taxation, for spending indicates the extent to which resources are diverted from private to governmental uses, regardless of how it is financed. Taxation reduces private consumption spending; borrowing reduces private sector investment; and money creation crowds out private spending by reducing the real value of privately held wealth. Thus, a more accurate view of the burden of taxation is provided by government spending than by tax revenues (and an even more accurate account would include the costs of government regulation). By framing the issue of tax reform solely in the context of how to reorganize one particular means of financing government spending—income taxation—the reformers are involved in an exercise not unlike rearranging the chairs on the deck of the Titanic.

Another point Professor Wagner makes that deserves closer scrutiny is his comment that even though a flat tax *may* generate some benefits such as lower costs of tax administration and lower "welfare losses," it would "do nothing to address the Tullockian, rent-seeking rectangles" (p. 398). He refers here to the diagrammatic explanation of "rent seeking"—the use of resources to obtain, maintain, and extend economic rents through the aegis of the state (Tullock 1967). Lobbying for tax loopholes or for higher taxes imposed on one's competitors are examples of such rent seeking.

Politicians benefit by treating citizens unequally before the law: They grant tax preferences or loopholes to politically powerful groups in return for votes and campaign contributions from those groups. This is surely one fundamental reason why the tax code, over the years, has become so complicated. But if this is true, one might ask, why would politicians support a tax reform bill that would eliminate most of the loopholes they have created (and benefited personally from)? If granting loopholes is politically profitable, it would seem irrational for politicians to support a tax reform law eliminating most loopholes. I would like to offer one possible explanation of this "puzzle." The granting of tax loopholes by politicians is subject to diminishing returns, just as all other activities are. The marginal

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political benefit of granting additional tax preferences will fall over time. It is also likely that the marginal political costs (to the politician) are rising, for with increased complexity of the tax system comes greater dissatisfaction on the part of voters who complain that the tax system is too complicated and unfair. Thus, at some point it is no longer politically profitable to create further loopholes. Politicians who support a flat tax are hoping to win political support by appealing to the taxpayers' frustration over a tax system that is widely held as extraordinarily cumbersome and inequitable. But once the slate is wiped clean and most loopholes are eliminated, the same politicians who benefited from voting for some version of a flat tax can then benefit further by "starting over" and granting more loopholes, the marginal political value of which would then be relatively high. Thus, one can possibly view the current tax reform legislation as part of the ongoing game of rent seeking in which more and more resources are diverted from market activity to the activity of trying to influence the governmental authorities. If so, Professor Wagner's point is well taken: The flat tax does not even address the problem of rent seeking. As long as government has the power to forcefully take one person's income and give it to another (keeping some for itself), rent seeking will remain a major problem of democratic government, regardless of how taxes are collected.[2]

Finally, I would like to comment on Professor Wagner's suggestion that those interested in the issue of tax reform embrace the contractarian perspective as developed in Buchanan and Tullock's (1962) *Calculus of Consent* and in Buchanan's later work (1975; 1977), to mention a few examples. This perspective seems quite reasonable to those of us who value the Lockean principle of self-ownership, since "the standard of evaluation for policy outcomes must ultimately be a standard of consent among the participants" (Wagner, p. 000). A "good" tax system, says Professor Wagner, cannot be determined apart from the interests of the citizens when people and their rights come first. The effects of the tax system on savings, capital accumulation, and economic growth are not legitimate evaluation criteria if the interests of the people who constitute the polity in question are ignored.

A problem I have with the contractarian perspective, however, is that with issues such as tax reform there is never likely to be *unanimous* consent. If one uses the consent of the governed as a means of evaluating a tax system and chooses one system as "the best" because it commands, say, a 70 percent majority vote rather than a 51 percent

[2]Mancur Olson (1982) believes rent seeking is a major cause of economic stagnation.

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majority, one is still advocating coercing others into accepting one's views. This does not seem to be in principle any different from using standard welfare economics to justify governmental coercion.

Another problem with the contractarian approach is that it sometimes talks not of actual unanimous agreement but rather of "conceptual" agreement: ". . . it is the conceptual agreement among all participants at the constitutional stage or in some original position that is the essential element of fairness" (Buchanan 1977, p. 130). My interpretation of this approach is that it is supposedly legitimate for a group to exercise dominance over another through the political process as long as the dominating group can convince itself that even though there is no concrete unanimous agreement, they are acting in accordance with "conceptual unanimity."[3] Policies that would command conceptual unanimity are usually derived from specific theories in the contractarian literature. But it seems to me that these theories can be used to justify government coercion just as easily as the social welfare function approach can. I do not see much difference between trying to impose one's will on others by calling it conceptual unanimity and appealing to a social welfare function to accomplish the same ends. Both approaches are attempts at social engineering. As long as government is allocating resources there will be no unanimous consent. There can only be unanimous consent in private markets, given well-enforced property and contract rights. Accordingly, if one believes consent is a desirable policy criterion, the only substantive proposal one can make is of a reduction in the size, scope, and power of government, by whatever means. Only by privatizing government and encouraging free enterprise can the domain of cooperative behavior be expanded. The mere existence of government implies coercion, and I do not believe this can be "conceptualized" away.

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IS THE FLAT TAX A RADICAL IDEA?

James Gwartney and James Long

Recent proposals to implement a flat rate federal income tax have revived the debate concerning the appropriate rate structure. Despite the renewed interest in this question, particularly among academicians and politicians, there is much confusion surrounding the issue of flat rate taxation. No doubt some Americans incorrectly interpret a "flat tax" as one that imposes the same liability on low- and high-income taxpayers. Of course, under a true flat rate tax only the average (and marginal) *rate* of tax is equal for all income levels; the *dollar* liability rises proportionally with income. Another myth of flat rate taxation is that it would constitute a radical departure from a federal income tax which has been in place for over 70 years. During the first 50 years of its existence, after making allowance for personal exemptions, the U.S. income tax imposed approximately the same marginal tax rate on all except the top 5 percent of income recipients. Progressive marginal rates rising throughout the income structure as income increases 10 or 15 percent are actually a relatively new phenomenon, attributable primarily to the inflationary bracket creep of the 1970s.

As an alternative formulation to the title of this paper, we would like to pose the following question: "How strong is the case for progressive income taxation?" After section I presents a brief historical overview of the income tax in the United States, section II analyzes the philosophical underpinnings of progressive taxation. Sections III and IV consider practical problems with progressive taxation that substantially reduce its ability to accomplish the objectives of its proponents. Finally, sections V and VI consider the impact of progressive taxation on tax avoidance and economic efficiency, respectively.

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I. The Federal Income Tax: A Historical Look

When the federal income tax was established in 1913, the marginal tax rates ranged from 1 percent to 7 percent. At least one U.S. senator voted against the tax because he feared that someday rates might run as high as 14 percent, a level he considered confiscatory. With regard to the likelihood of increasing marginal rates, the senator's fears were more than realized. During World War I, the top marginal rate was eventually raised to 73 percent. Except for a brief period during the 1920s, the top marginal rate has been 50 percent or more.

Focus on the rate structure alone, however, conceals the transformations of the federal income tax. In the United States this tax has gone through three rather distinct phases. These phases can be seen in the data presented in Table 1. First, there was what might be called the "income tax is for the few" phase covering the 1913–40 period. Only a small number of Americans, the top 10 percent or so of income recipients, paid income taxes. Most were not even required to file a return. Prior to 1940, the number of returns as a percent of

TABLE 1

SELECT DATA ON THE FEDERAL PERSONAL INCOME TAX, 1913–1982

Year	Returns as a Percent of Households	AGI as a Percent of Personal Income	Range of Marginal Tax Rates	Income Tax Revenue as a Percent of Personal Income	Percent of Returns Taxed at MTR of 28 Percent or More
1913	2	16	1–7	0.2	NA
1920	30	36	4–73	1.4	0.2
1925	15	33	1.5–25	1.0	0.0
1935	15	29	4–63	1.1	0.2
1945	133	71	23–94	10.0	NA
1955	121	80	20–91	9.5	NA
1960	114	79	20–91	9.8	3.0
1965	117	80	14–70	9.2	2.7
1970	117	78	14–70	10.1	6.5
1975	115	75	14–70	9.8	12.0
1980	118	75	14–70	11.6	26.0
1982	113	72	12–50	10.8	NA

SOURCE: U.S. Bureau of Census, *Statistical History of the United States from Colonial Times to Present;* Internal Revenue Service, *Individual Income Tax Returns* (annual); Barro and Sahasakul (1983).

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households reached 30 percent during only one year, 1920. Throughout most of the period, less than one-sixth of the households were required to file returns. For example, during the 1925–31 period, a married couple was not required to file unless their net income exceeded $3,500 (or gross income exceeded $5,000). Given that nominal *per capita* incomes have increased more than twelvefold since 1930, it is easy to see why so few were required to file. The $3,500 plateau would be the equivalent of approximately $42,000 given today's income structure.

In the second phase, which began with World War II and lasted into the early 1960s, the income tax resembled a quasi flat tax. The tax was generalized to the entire population. The number of returns consistently exceeded the number of households.[1] Adjusted gross income of returns jumped to approximately 80 percent of personal income, up from less than 35 percent throughout most of the pre-1940 period. However, except for the top 4 or 5 percent of earners, taxpayers confronted approximately the same marginal tax rate. While the rate structure spread to exceedingly high rates (the maximum rate was 91 percent throughout most of the period), few taxpayers earned incomes such that the high rates were applicable.

Figure 1 uses the 1962 data to illustrate the flatness of the structure during the period. Here we show the cumulative percent of returns (ranked according to income) confronting alternative marginal tax rates in 1962 and 1981. In 1962, the personal exemption amount excluded approximately one-fifth of the income recipients from tax liability. Taxpayers ranked from the 20th percentile to the 89th percentile all confronted marginal rates of 20 percent to 22 percent. For those with incomes in the 89 to 96 percentiles, the top marginal rate was 26 percent. Only the top 2 percent of taxpayers paid marginal tax rates of 30 percent or more in 1962. *Thus, as recently as the early 1960s, the structure of the income tax in the United States was essentially that of a flat tax (except for the top 3 or 4 percent of earners) with a personal exemption level which excluded the bottom one-fifth of returns from tax liability.*

Third, since the mid-1960s the structure of the income tax has changed rather dramatically. During this period for the first time, we moved to a generalized progressive income tax. With the increase in number of brackets in 1964 and the inflationary bracket creep of the 1970s, the progressivity of the rate structure increased substantially. In contrast with 1962, by 1981 taxpayers at the 75th percentile of the

[1]The excess of number of returns relative to households reflects the multifiling in many households with more than one earner.

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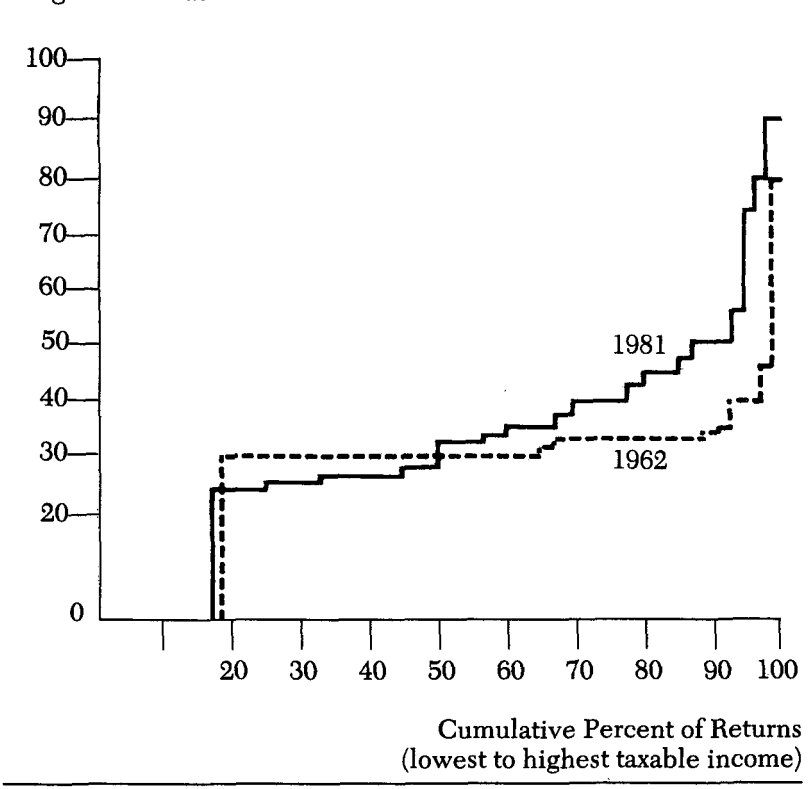
FIGURE 1

PROGRESSIVITY OF MARGINAL TAX RATES: 1962 VS. 1981



SOURCE: Internal Revenue Service, *Individual Income Tax Returns: 1962* and *SOI Bulletin* (Fall 1983): 44.

distribution paid a marginal tax rate twice (28 percent compared to 14 percent) their counterparts at the 25th percentile. Of course, there was a substantial increase in the number of taxpayers confronting high marginal rates. By 1980, 26 percent of taxpayers faced federal marginal rates of 28 percent or more, up from only 2.7 percent as recently as 1965 (see Table 1, column 5).

II. The Philosophical Case for Progressive Taxation

The proponents of progressive taxation generally base their case on the concepts of ability-to-pay and the diminishing marginal utility of income. They argue that persons with larger incomes have more

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resources with which to pay taxes and that they tend to value marginal units of income less. Thus, collecting a disproportionally large share of tax revenues from high income taxpayers imposes the burden on those best able to afford it while minimizing the welfare cost of taxes.

Walter Blum and Harry Kalven (1953) analyze these arguments in a fascinating little book written more than three decades ago. They conclude that the philosophical case for progressive taxation is an uneasy one. The reasons for their conclusion are worth reviewing. As Blum and Kalven note, ability-to-pay is a slogan, not a substantive concept. What does it mean? How is it measured? To the extent income is a measure of ability-to-pay, one would think that after allowance for some subsistence level, a person with twice the income of another would have twice the ability-to-pay. If so, why should the former be taxed more than twice as much? Economic theory fails to provide an answer.

Suppose one wants to impose an equal tax burden on the rich and poor alike. Assuming diminishing marginal utility of income, would this equal sacrifice principle justify progressive taxation? Surprisingly, the answer is, "not necessarily." As Blum and Kalven discuss in detail, the marginal utility of money must not only decline with income, it must decline *more rapidly* than income increases in order to justify progressive taxation under an equal sacrifice theory. Since there is nothing in economic theory that implies such a rapid decline in marginal utility, the equal sacrifice principle is unable to provide ethical underpinnings for progressive taxation.

Suppose one wanted to minimize the welfare cost of taxation—to take each dollar of taxation from the recipient who valued it the least. Would this principle justify progressive taxation? Once again the case is shaky. If the marginal utility of money is inversely related to income and neither the rich nor the poor alter their income-generating behavior in response to taxation, a welfare cost minimization theory would imply a topping off of incomes until the required number of tax dollars were obtained. Persons with incomes above the topping-off income level would confront 100 percent marginal tax rates. Such confiscatory rates, however, would destroy the incentive to produce income. The welfare cost advantages of taxing only income yielding the lowest marginal utility therefore must be balanced against the utility losses due to loss of income.

In addition, the welfare cost minimization theory suffers from a still more significant deficiency, a deficiency that also applies to all theories based on the diminishing marginal utility of income. Economic theory does *not* imply that a person with more income derives less marginal utility from income than a person with less income.

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The law of diminishing marginal utility applies to an individual at a point in time. It has no application across individuals. There is simply no way anyone, including a benevolent despot, can determine whether one individual derives more or less utility than another individual from an additional dollar of income (see Robbins 1935, pp. 136–43). Thus, there is no way it can be determined whether individual *A* is better able to bear the taxation burden or would lose less utility than individual *B*.

Neither can the theory be rescued, as the English economist A. C. Pigou sought to do, by assuming that individuals have a similar capacity to enjoy income. The preferences of individuals differ with regard to the television programs they enjoy, social activities they choose, and a thousand other matters. Why should preferences not also vary with regard to work-leisure, time preferences, and other factors that influence income? In fact, work effort data indicate they do. Persons who earn higher incomes work longer hours, move more often in order to upgrade their salaries, spend more time and money developing and maintaining their skills, and labor under additional pressure (as measured by such things as the incidence of ulcers and nervous disorders). These actions suggest that, even at the margin, many persons with high incomes place a high evaluation on income and the things it can buy.

There is also reason to believe that factors such as family background, age, and source of income influence the marginal utility of income, *independent of the income level.* An offspring of a poor family is likely to derive considerably more utility from $25,000 of income than would be derived by the son of a millionaire. A youthful family just starting out in life may place a considerably higher valuation on additional income than a retiree with the same amount of income. The process which generates the income is also likely to make a difference. The personal utility derived from income earned in the marketplace is likely to differ from "income" received from inheritance or transfer payments, for example.

Progressive taxation cannot be justified by broadly accepted ethical principles of taxation. In the final analysis, the foundation of progressive taxation is simply a preference for economic equality. As Henry C. Simons (1938), an advocate of progressive taxation, put it: "The case for drastic progression in taxation must be rested on the case against inequality—on the ethical or aesthetic judgment that the prevailing distribution of wealth and income reveals a degree (and/or kind) of inequality which is distinctly evil or unlovely" (pp. 18–19).

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The strength of the case for progressive taxation must rise or fall, therefore, on the basis of its effectiveness as an egalitarian weapon. Before we investigate this topic, one final philosophical point must be made. One cannot help but be struck by the lack of respect for individual claims implicit in the welfare maximization and allocation of burden arguments for progressive taxation. The emphasis is entirely on end results. The analysis proceeds as if all income belongs to the government, which in its wisdom, often finds it advantageous to permit those with higher incomes to keep some of their additional earnings since failure to do so would drastically reduce the size of the economic pie. But in doing so the social welfare maximizers and benevolent despots alike are motivated by pragmatic realism, not recognition of valid claims belonging to individuals who acquired income via voluntary exchange without the use of violence, theft, or fraud. The process by which income is acquired matters not at all in this world. Clearly, this view is a long way from the Lockian concept of government on which Western civilization was founded.

III. Does Income Measure Economic Status?

If progressive taxation is going to promote economic equality, annual income must be a reasonably accurate indicator of economic status. If it is not, the high tax rates intended for the well-off will be levied on other taxpayers who are not so well off. Perhaps surprising to some, annual income is often a misleading indicator of economic well-being. There are four major reasons why this is the case.

1. *Annual income differences partially reflect life-cycle factors rather than real differences in economic status.* Over our lifetimes, most of us go through three phases. First, there is a "skill-development" phase during which we spend a substantial amount of our time and energy acquiring knowledge and developing skills. By way of comparison with our expected future income, current annual income is low during the skill-development phase. Next there is the prime-earning years. Emphasis shifts from skill development to utilization. During this phase, which generally covers ages 30 through the mid–50s, annual income tends to overstate our economic well-being, making us look richer than we really are. Finally, there is the retirement phase, characterized by less work and more leisure. Even households that are quite well-off tend to experience low annual incomes during the retirement phase.

Annual income data illustrate the importance of these life-cycle factors. In 1981 the mean family income of households headed by a person in the prime-age 45 to 54 grouping was $30,090, comparing

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to $15,073 for families headed by a 15 to 24 year old and $14,246 for families headed by a person 65 years and over (U.S. Department of Commerce, 1981a, Table 10). Thus, annual income was approximately twice as great for prime working-age families as was true for their counterparts during the skill development and retirement phases of the life-cycle.

During the skill development and retirement phases, families with average incomes (for their age grouping) appear to be poor. Thus, the bottom quintile of income recipients is heavily populated by households headed by persons experiencing this phase of the life-cycle. For example, in 1981 households headed by a person either under age 25 or over age 64 years comprised only 17.8 percent of total households, but they accounted for 61.1 percent of the bottom quintile of low-income households.

In contrast, prime-age persons with only an average income (for their age grouping) appear among the high-income earners. For example, an average income for a household headed by a person age 45 to 54 years would place it among the top 25 percent of income recipients when all age groupings are considered. Unsurprisingly, prime-age households dominate the upper income brackets. The 35 to 64 age groupings, meanwhile, accounted for less than half of the total households but comprised nearly three-fourths (73.8 percent) of the top quintile of income recipients.

Given the variation of income attributable to life-cycle factors, annual income is not a very good indicator of economic status. Annual income data make it appear that people are not well-off when, in fact, they are merely acquiring skills or enjoying retirement. Simultaneously, other people are made to appear quite well-off during their prime earning years when, in fact, they are not nearly so well off as their annual income implies.

2. *Higher annual incomes partially reflect locational cost-of-living differences rather than real differences in income.* In 1980, the cost of purchasing the typical bundle of goods and services consumed by a family of four was 29 percent more in New York City than in Dallas, and 28 percent more in Boston than in Atlanta (U.S. Department of Commerce, 1981b, Table 786). While these differences are sizable, cost-of-living differences between most large, densely populated urban areas and small-to-median size towns (and rural areas) are generally even greater.

Of course, if prices are *on average* 30 percent higher in one area than another, 30 percent more income will not buy more goods and services. Thus, a household with $39,000 of income in New York City is no better off than an identical family with an income of $30,000

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in Dallas. But our progressive federal tax structure treats the New York family as if it were better off. Federal taxes take a larger share of the New York family's income, leaving it with less real income than the lower taxed Dallas family.

Like prime-age earners, persons living in large urban areas with a high cost-of-living are overrepresented among high-income (and highly taxed) earners. In 1981, only 43.6 percent of households were located in urban areas with a population of one million or more. But these large urban areas supplied 51.3 percent of the income recipients in the top quintile. The high money income of households in large urban areas at least partially reflects cost-of-living factors rather than real income differences. Nonetheless, a progressive tax structure imposes higher rates on the larger nominal incomes, even when they are merely reflections of cost-of-living differences.

3. *Annual income is often a misleading indicator of economic status because it fails to account for differences in work effort and availability of nonmarket time.* Like market goods, nonmarket time contributes to our well-being. As modern microeconomic theory emphasizes, the *full-income* of a household is a reflection of utility generating commodities produced with a combination of market goods and nonmarket time (Becker 1965; Becker and Michael 1976). Many commodities such as watching television, playing games, reading books, jogging, and hiking are quite time intensive—that is, they require relatively more nonmarket time than market goods.[2] Nonmarket time may also be used to produce goods (food, clothing, laundry service, etc.) that would otherwise have to be purchased with market income. Despite the importance of nonmarket time to our standard of living, tax legislation is structured as though market income (and goods) were the sole source of economic well-being. Families that sacrifice nonmarket time in order to gain money income are doubly penalized by progressive taxation. They not only have less nonmarket time because of their greater work effort, but in addition progressive taxation takes a *larger percentage* of the market income derived from their work effort.

In many cases, the major distinction between high and middle (and middle and low) income families is the quantity and intensity of work force participation. In recent years, the top fifth of family income recipients have contributed more than 30 percent of the total weeks

[2]Since the opportunity cost of time is directly related to one's wage rate, time-intensive commodities are more expensive for high-wage than low-wage earners. This higher "price" of time-intensive goods such as vacations, hunting, fishing, and television watching serves to reduce the *full income* differences between high- and low-money income recipients.

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worked compared to only 8 percent for the bottom quintile. Among high income husband-wife families in 1981, more than three-fifths (61.7 percent) of the wives worked outside the home compared to 42.3 percent of the wives in middle income families, and only 17.8 percent of the wives of low income families. The differences in full-time participation of working wives were even greater. Full-time working wives characterize 46.1 percent of the high income families compared to 27.3 percent of the middle income families, and only 9.2 percent of the low income families. Therefore, the wife was five times more likely to work full-time in high income families than in low income families.[3]

While data are unavailable on the intensity of work effort, economic theory indicates that acceptance of additional responsibility and job pressure, a more hectic work pace, and less desirable working conditions will be associated with higher incomes. The market income of individuals accepting positions requiring intense work effort will overstate their full income. Income statistics will make it appear that workaholics are better off than leisure lovers with the same full income. Under a progressive system, the former will be penalized relative to the latter, independent of full income.

4. *Since the number of family members tends to increase with income, annual income differences exaggerate differences in living standards.* In 1981, the average size of high income (top 20 percent) households was 3.4 members, compared to 1.9 members for low income families. While only 12.1 percent of the low income households had four or more members in 1981, 43.5 percent of the high income households fall into that category. A larger family must feed more mouths, clothe more bodies, and provide more shelter. Thus, a larger family with more income may not be better off than a smaller family with less income. The personal exemption and different rates for separate filing categories built into our tax structure make some allowance for this factor. However, they are unlikely to compensate

[3]One might suspect that these rather dramatic differences reflect the age composition of the households. However, this is not the case. *Within age groupings*, the incidence of working wives is still far greater among high income than low income households. The incidence of working wives for prime-age (35 to 54 years) families is given below:

Husband-Wife Families with Household Head Age 35 to 54 Years	Annual Income 1981		
	Bottom 20 percent	Middle 20 percent	Top 20 percent
Percent with:			
Wife employed	29.9	47.6	66.9
Wife employed full-time	17.1	30.3	48.6

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fully for the expenses associated with an additional family member. As a result, progressive taxation will often tax families with *less per capita* income (and a lower standard of living) at *higher rates* than smaller families with a high economic status.

Some examples can be given to illustrate the above points and, therefore, to answer the question of whether income is a good measure of economic status. One way to approach this question is to ask yourself, "Is a family with an annual income of $40,000 better-off than one with a $20,000 annual income?" Reflection on the issue indicates that it is highly complex. For example, suppose the high-income family lives in a high cost-of-living area such as New York or Chicago. They have three children, both husband and wife are employed, and their commute time to and from work is one hour each way. Transportation, suitable clothing, and child care services are major items in their family budget. Given the time spent working and commuting, the family has little nonmarket (leisure) time.

In contrast, suppose the $20,000 per year family lives in a small town or rural area where the cost-of-living is low. The husband's commute time to work is measured in minutes, not hours. The wife does not work outside of the home and the family has only one child. Given the work and commute time of this family, they have considerably more nonmarket (nonwork) time. It is not at all obvious that the high income family will even be able to purchase more market goods for household consumption. Given its smaller family size and greater leisure time, the standard-of-living of the low income family is almost certainly higher than the family with twice as large an income.

Consider another example. Suppose the $40,000 income represented the joint earnings of a typical middle-aged working couple striving to pay the mortgage, keep the kids in school, and save for their college education. On the other hand, suppose the $20,000 represents the interest and pension income of a childless, retired couple who own a comfortable home. Again, once one accounts for differing circumstances including family responsibilities and availability of nonmarket time, the family with the lower money income almost surely lives more comfortably than the high income family.

These examples are not atypical. As Table 2 summarizes, high income families are more likely to confront circumstances that reduce their overall standard-of-living. By way of comparison with low income households, high money income households are more likely to be characterized by prime-age workers, residence in a high cost-of-living area, larger family size, working wives, less nonmarket time, and a greater investment in human capital. Given these characteris-

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TABLE 2

SELECTED HOUSEHOLD CHARACTERISTICS FOR LOW, MIDDLE, AND HIGH INCOME HOUSEHOLDS IN 1981

Characteristic	Annual Income 1981[a]		
	Bottom 20 Percent	Middle 20 Percent	Top 20 Percent
Percent of Households			
Age: 35–64	31.5	45.9	80.0
15–24	9.7	8.5	1.6
65 and over	45.6	15.4	7.9
Percent of Households Located in Metropolitan Area of 1,000,000 or more	35.9	36.3	51.3
Average Size of Household (NO. OF PERSONS)	1.9	2.7	3.4
Average Number of Earners	0.5	1.4	2.2
Percent of Husband-Wife Families with a Working Wife:			
Employed	17.8	42.3	61.7
Employed Full-time	9.2	27.3	46.1
Mean Years of Schooling	10.7	12.5	14.4

[a]The annual income of the three brackets is: less than $8,024 (bottom 20 percent), $15,000–$23,000 (middle 20 percent), and above $34,300 (top 20 percent).

SOURCE: U.S. Department of Commerce, *Money Income of Households, Families, and Persons in the United States: 1981*, Tables 5, 11, 12, and 23.

tics, it is clear that annual income often overstates their economic well-being. Annual income often categorizes families as rich (and therefore prime candidates for heavy taxation) when closer inspection reveals that they are less well-off than many others who are taxed less heavily. Similarly, annual income will often place families among those to be moderately taxed, even though they are less well-off than others with an annual income that qualifies them for various types of income transfers.

IV. Market Adjustments and Eroding the Redistributive Effects of Progressive Taxation

Even if income could be measured in such a manner that progressive taxation would impose larger statutory tax burdens on those with larger real lifetime incomes, its redistributive power would tend to

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be thwarted by adjustments in the quantity and allocation of factor supplies, particularly labor. In the traditional analysis of the economic incidence of an income tax, changes in the relative supplies of labor and capital determine the distributional impact of the tax. If labor and capital inputs are unresponsive to taxation, the distributional impact is identical to the rate structure. Under such circumstances, progressive taxation tends to equalize after-tax income.

However, when tax rates exert a differential impact on the supply of labor relative to capital, the egalitarian impact of progressive taxation becomes less certain. If the progressive tax rates reduced labor supply relative to capital, wage rates would rise relative to returns to capital. Since low income recipients tend to derive more of their income from labor, the distribution of before-tax incomes would become more equal. But the opposite outcome is also a possibility. If progressive rates reduce the supply of capital relative to labor, returns to capital will rise relative to wage rates. Under these circumstances, the inequality of pre-tax income will increase. Thus, the ability of progressive taxation to promote income equality is dependent on the relative sizes of labor and capital supply elasticities.

Unfortunately, empirical evidence on factor supply is highly controversial and there is no consensus on how large an impact income taxes have on work effort and saving. According to Boskin (1978), taxation of the income from capital has substantially reduced saving in the United States. A recent study by Hausman (1981) concludes that the current progressive income tax has significantly reduced labor supply and, in the case of husbands, that the largest tax response arose in the case of high-skill persons earning high wages. If these findings are correct, if high marginal tax rates have reduced capital formation and retarded the supply of high-skill labor, then progressive taxation has almost certainly worsened inequality by increasing the market returns to capital and high-skill labor relative to the wage of low-skill labor.

However, even if *aggregate* labor supply is unaffected by progressive income taxation, market wage rates will adjust in a manner that will tend to erode the redistributive effects of progressive taxation. Earnings differences do not just happen—they are not like lottery tickets drawn from an urn. Rather, they reflect the choices of buyers and sellers in the marketplace. In the long-run, high wages reflect compensation for necessary human capital investments and less attractive job attributes. Work opportunities requiring costly education, training, and skill-building experience will be unable to attract workers unless they offer earnings sufficient to compensate suppliers for their sacrifices. Similarly, positions requiring intense work effort,

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long and inconvenient hours, frequent locational moves and/or out-of-town travel, unstable employment patterns, residence in less desirable areas, substantial employee risk, and/or other less desirable attributes find it necessary to compensate suppliers for these less attractive job characteristics. In the absence of taxes, a set of wage differentials emerge which reflect these conditions.

The introduction of progressive taxation compresses after-tax wage differentials by reducing the supplier's rate of return on human capital investment and his compensation for less desirable job attributes. Individuals also will adjust their choices to the new incentive structure.[4] Fewer individuals will undertake costly human capital investments and fewer will accept the less desirable job attributes at the lower after-tax earnings levels that are no longer sufficient to compensate them for their sacrifices. The supply of labor to highly taxed categories will decline causing wage rates to rise until the after-tax net returns in these areas are once again normal (equal to what can be earned on similar investments). In occupational categories (primarily low wage occupations) taxed less heavily via a progressive system, just the opposite will occur. More people will enter such occupations, depressing wage rates until eventually normal returns are restored in the low-tax occupations. As the result of supply shifts induced by progressive taxation, a different set of pre-tax wage differentials will emerge.[5] This reallocation of labor and human capital investment will increase the pre-tax inequality of the earnings distribution and, at least partially, offset the intended egalitarian effects of progressive taxation.

Many economists are fond of calculating the Gini coefficient before and after taxes, measuring the redistributive effects of progressive taxation to the third decimal point. Our analysis indicates that such comparisons are seriously flawed because they are based on the

[4]A principle economists refer to as "the rate of return equalization theorem" underlies the adjustment process. Once allowance is made for factors such as risk, nonpecuniary benefits, and taxes, market forces will tend to equalize the rate of return across investments in human and physical capital. Investment opportunity A cannot permanently yield a lower net return than alternative B because the lower net return in A will induce individuals (and investment funds) to shift to B, thereby depressing the return in B and increasing the return in A. The process will continue until, at the margin, the rates of return are equal. As long as individuals are free to make decisions about how to use their time, energy, and resources, they will reallocate resources so as to equalize marginal rates of return across alternative opportunities.

[5]See Wagner (1983, pp. 187–201) for an excellent, technical treatment of the distributional effects of progressive taxation. Also see Holcombe (1981). For evidence of labor supply shifts between wage and salary work and self-employment, see Long (1982).

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assumption that the pre-tax distribution of income is invariant to taxation. Economic theory indicates this is not the case. However, since we cannot directly observe what the distribution of pre-tax income would have been in the absence of progressive taxation, the importance of the market adjustment is difficult to ascertain. Nevertheless, recent empirical work by Morgan Reynolds and Eugene Smolensky (1977) does shed some light on the topic. Examining income distribution data for the 1950–70 period, Reynolds and Smolensky found that the degree of inequality in after-tax and transfer income in the United States was roughly the same in 1970 as in 1950. The relative size of government approximately doubled between these two periods. Direct income transfers and social welfare expenditure increased even more rapidly. More and more people were pushed into high tax brackets in order to finance the expansion in government expenditures. Yet, despite this vast expansion in redistributive activities, the degree of after-tax inequality was roughly the same. As a result of their study, Reynolds and Smolensky question the ability of government to redistribute income: "It appears to be a common view that, even in a predominantly market economy, the distribution of income, however defined, is subject to government modification. We are not convinced that the conventional wisdom is correct" (1977, p. 96).

The recent work of Joseph Pechman and Mark Mazur (1984) on the after-tax income share of the top 15 percent of income recipients also indicates there has been little change in the after-tax distribution of income during the last three decades. Pechman and Mazur use tax return data to calculate the share of before- and after-tax income of the top 15 percent of recipients during the 1952–81 period. As Table 3 shows, prior to adjustment for taxes and transfers, the income share of the top 15 percent of earners rose from 33 percent to 38 percent of the total. Given the tax rate increases over this period, this pattern is consistent with the market adjustments outlined above. However, both cash and noncash transfers rose sharply during the period. Once adjustment is made for transfer income, the data indicate that there was little change in the after-tax and transfer income share of the top 15 percent of earners between 1952 and 1981. Thus, despite a substantial increase in the progressivity of the income tax (see Table 1 and Figure 1) and a tripling of transfer payments as a percent of personal income, the share of after-tax income going to top earners was altered little. Given market adjustments to taxes and transfers, this is precisely what one would expect.

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TABLE 3

INCOME SHARE OF TOP 15 PERCENT OF TAX UNITS

Year	Share of Nontransfer Income Received by Top 15 Percent: Before-Tax	Share of Nontransfer Income Received by Top 15 Percent: After-Tax	Cash Transfers as a Percent of Personal Income	Share of Top 15 Percent: After-Tax and Cash Transfers[a]	Noncash Transfers as a Percent of Personal Income	Share of Top 15 Percent: After-Tax and Cash Plus Noncash Transfers[a]
1952	33	30	4.8	28.6	0	28.6
1963	35	33	7.7	30.6	1.0	30.4
1981	38	35	13.9	30.7	4.1	29.7

[a]The calculations assume that all of the cash and noncash transfer benefits were allocated to households in the bottom 85 percent of the distribution.

SOURCE: The first two columns are from Pechman and Mazur (1984, Tables I and III). Data on cash and noncash transfers are from the Council of Economic Advisors (1984) and the U.S. Department of Commerce (1984).

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V. Progressive Taxation, Tax Avoidance, and Effective Tax Rates

The "productivity" of progressive taxation as an input in tax-transfer policies to promote greater equality is further limited by the impact of high marginal tax rates on the taxable income base. There is substantial evidence to suggest that increases in federal tax rates resulting from inflation and an unindexed progressive income tax have contributed to the growth of nontaxed fringe benefits as a share of employee compensation (Long and Scott 1982; Woodbury 1983). Charles Clotfelter (1983a, 1983b) has shown that higher tax rates stimulate both tax evasion and tax avoidance, the latter resulting from the greater incentive of business proprietors to purchase deductible inputs that provide personal utility, such as travel and entertainment. Other types of consumption that are tax deductible (for example, housing expenses and charitable giving) have also been estimated to be responsive to changes in tax rates. Since increases in fringe benefits, tax evasion, and deductions reduce the tax base, the current progressive tax structure may generate a lower level of revenue to finance redistributive transfers than might otherwise be collected.

Of all the forms of tax avoidance, there is some suspicion that "tax shelters" are the most serious (Barro and Sahasakul 1983). The most widely used tax avoidance techniques generate accounting losses while moving income into lower tax categories (for example, taking capital gain income or deferring income to the retirement phase of one's lifetime). As Table 4 shows, accounting losses have increased substantially as more and more taxpayers confronted high marginal rates during the 1966–81 period. In 1981, 3.3 percent of the joint returns showed net losses from partnerships, up from less than 1 percent in 1966. The number of joint returns with losses from business and professional practice rose to 5.2 percent in 1981, up from 1.9 percent in 1966. The percent of returns with losses from rents, farming, and small business corporations were also sharply higher during the 1966–81 period. As a percent of adjusted gross income (AGI), the dollar losses from the five sources shown in Table 4 were three times greater in 1981 than 1966. While aggregate statistics such as these are consistent with the hypothesis that rising tax rates erode the tax base, they lack the precision necessary to estimate the impact of high marginal tax rates on tax revenue.

Seeking to estimate this relationship more precisely, we obtained detailed data on income, losses, and deductible expenditures from the *1979 Individual Tax Model File* of the Internal Revenue Service. Tax avoidance was defined as the sum of (a) gross losses from

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TABLE 4

NET INCOME LOSSES FROM TAX AVOIDANCE
(SELECTED YEARS)

	1966	1973	1979	1981
Number of Joint Returns (In millions)	40.2	43.6	44.9	46.7
Form of Tax Avoidance	Percentage of Joint Returns Showing a Net Income Loss			
Rents	4.5	4.8	5.9	6.8
Business and Professional Practice	1.9	3.0	3.9	5.2
Farming	2.2	2.4	2.6	3.1
Partnerships	0.8	1.5	2.1	3.3
Small Business Corporations	0.2	0.3	0.5	0.7
	Net Losses as a Percentage of Adjusted Gross Income			
Rents	0.39	0.44	0.75	1.12
Business and Professional Practice	0.45	0.53	0.73	1.01
Farming	0.47	0.58	0.75	1.16
Partnerships	0.31	0.78	0.96	1.77
Small Business Corporations	0.12	0.17	0.24	0.35
Total	1.74	2.50	3.44	5.40

SOURCE: Internal Revenue Service, *Statistics of Income: Individual Tax Returns* (annual).

partnerships, small business corporations, and estates or trusts plus net losses from rents, royalties, business, farming, and other sources plus (b) deductions for all itemized deductions except state and local income taxes paid and the sum of adjustments to income (that is, payments into an individual retirement account [IRA] and other expenses included in Line 30, Form 1040). This measure of tax avoidance was regressed on the combined federal-state marginal income tax rate the taxpayer would confront in the absence of tax avoidance.[6]

State marginal tax rates range from zero in states without an income tax to maximum rates in the teens in several other states.[7] In addition,

[6]A more detailed description of the model and variables is provided in Long and Gwartney (1985).

[7]Florida, Nevada, North Dakota, Texas, Washington, and Wyoming did not levy a state

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the federal income tax rate in 1979 varied with the source of income. A 50 percent statutory rate applied to personal service income (essentially, labor earnings) while marginal rates on other (capital) income ranged up to 70 percent. As a result, the combined federal-state tax rate could vary substantially among taxpayers with the same gross income, personal exemptions, and other characteristics. This variation in marginal tax rates allowed us to estimate the independent effect of higher tax rates on tax avoidance.

Our regression model took the form:

$$\text{tax avoidance} = f(\text{MTR, GI, PE, AGE 65, INCAVG})$$

where:

MTR	is the combined marginal federal and state income tax rate the taxpayer would confront in the absence of deductible expenditures and deductions for losses,
GI	is the gross income of the tax return,
PE	is the number of personal exemptions,
AGE 65	is a dummy variable indicating the taxpayer is age 65 or over, and
INCAVG	is a dummy variable indicating taxpayers using the income averaging method to calculate their tax liability.

Since we expected tax avoidance to vary as marginal tax rates (and gross income) increase, the model was estimated for joint returns in seven different income groupings.[8]

Table 5 summarizes the relevant findings. For gross incomes of less than $40,000 and combined marginal tax rates of 36 percent or less, the impact of tax rates on avoidance was negligible. However, for gross incomes above $40,000, higher rates exerted a substantial positive impact on tax avoidance. For the $40,000–$60,000 grouping, tax avoidance increased by $162 for each one unit increase in marginal tax rates, independent of the impact of gross income, age, personal exemptions, and income averaging. For the $60,000–$95,000 grouping, a unit increase in MTR was associated with $715 of additional tax avoidance. The parallel estimates of additional tax avoid-

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income tax in 1979. In contrast, California, Delaware, Hawaii, Iowa, Minnesota, Montana, New York, and Wisconsin all levied maximum rates of 11 percent or more.

[8]The income ranges were chosen with the objectives of maintaining sufficient sample sizes and encompassing at least two federal tax brackets in order to allow maximum possible variation in the marginal tax rate measure. However, utilizing different income ranges does not alter the basic nature of our findings. The IRS data base provides sampling weights equal to the inverse of the sampling rate for each observation. This weight was applied to each observation in our analysis. When the data base is a stratified sample, failure to utilize weighted regression analysis can substantially alter the results.

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TABLE 5

ESTIMATED IMPACT OF MARGINAL TAX RATES ON TAX AVOIDANCE FOR VARIOUS INCOME CLASSES—JOINT RETURNS 1979

Pre-Avoidance Gross Income Class ($ thousands)	Mean Pre-Avoidance Combined Federal-State Marginal Tax Rate	Dollar Change in Tax Avoidance Associated with a Unit Increase in Marginal Tax Rate	Estimated Tax Base Elasticity
0–20	21.1	−26	.03
20–40	36.4	−10	.02
40–60	49.4	162	−.17
60–95	57.3	715	−.56
95–140	61.7	2,847	−1.56
140–200	64.4	5,148	−2.02
200+	66.4	7,979	−1.78

SOURCE: Derived from Internal Revenue Service, *1979 Individual Tax Model File and 1979 State Tax Model File.*

ance for other groupings were $2,847 for $95,000–$140,000; $5,148 for $140,000–$200,000; and $7,979 for the over $200,000 cell.

Since an increase in tax avoidance shrinks the tax base, our tax avoidance estimates can easily be converted to tax rate elasticities. The tax rate elasticity coefficient is equal to the percentage change in taxable income divided by the percentage change in the marginal tax rate. If the negative percentage change in the tax base (pre-avoidance "taxable" income in our case) is less than the percentage change in the tax rate, the elasticity coefficient will be less than one. Under these circumstances, higher (lower) marginal tax rates would lead to an expansion (contraction) in tax revenues. In contrast, when a change in the tax rate leads to an even larger change in the tax base, the tax rate elasticity coefficient will be greater than one. When this is the case, higher (lower) tax rates would lead to a reduction (increase) in tax revenues. Tax rate elasticity coefficients in excess of unity indicate that taxpayers in the grouping are on the backward bending portion of their Laffer curve.

Table 5 (column 3) presents the estimated tax rate elasticity coefficients for each of the income groupings. For incomes above $60,000 (and combined federal and state marginal tax rates above 49 percent), the estimated tax elasticities are quite large. The 0.56 estimate for the $60,000–$95,000 grouping implies that 10 percent higher mar-

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ginal rates shrink the tax base by 5.6 percent. For the three highest income groupings, the tax elasticity estimates exceed unity, indicating that lower rates generate more revenue in this range.

The rate variations in our model reflect a federal-state tax structure, the pattern of which has been in place for some time. Taxpayers have had time to adjust fully their tax avoidance strategy. In this sense, our estimates are long-run rather than short-run. Thus, our elasticities may overestimate the sensitivity of the tax base for the first year or two after a change in tax rates.

Since our methodology does not capture the effect of rising marginal tax rates on labor supply, tax evasion, employee fringe benefits, and other avoidance strategies which influence reported income, our estimates should be viewed as a lower bound. Nonetheless, they imply that combined federal-state marginal rates in the 50 percent and above range promote substantial amounts of tax avoidance activities. Given that many states levy income taxes with double-digit marginal rates, these estimates suggest that policymakers should seriously consider the appropriateness of *federal* marginal rates above the 35 to 40 percent range, particularly if the deductibility of state and local taxes is eliminated.

The empirical results presented above suggest that upper-income taxpayers are successful in using tax avoidance to reduce their effective tax rate, that is, their tax liability as a proportion of their pre-avoidance income. Thus, with tax avoidance the statutory progressivity is more apparent than real, at least in its ability to generate tax revenue from high income taxpayers. Of course, the high statutory rates and the tax avoidance that they induce may impose other types of costs (for example, exposure to additional risk, time and record-keeping costs, and payments to tax advisors), but these costs do not raise revenue for the taxing authorities.

The redistributive effectiveness of the progressive income tax can be gauged by comparing the effective and statutory rates across income groupings. Table 6 makes this comparison for the joint returns of the *1979 Individual Tax Model Sample*. The mean effective rate is the taxpayer's actual average tax liability divided by gross income. The hypothetical statutory tax rate was derived by calculating the tax due on a joint return claiming two dependents and deductions equal to 22 percent (the approximate average of itemized deductions as a percent of AGI) of their gross income.

The results indicate that the average effective and statutory rates were approximately equal for gross incomes of less than $40,000. However, as we anticipated from our analysis of tax avoidance, effective and statutory tax rates diverge as gross income rises above $40,000.

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TABLE 6

EFFECTIVE AND STATUTORY TAX RATES FOR VARIOUS INCOME LEVELS—JOINT RETURNS 1979

Gross Income ($ thousands)	Effective Average Tax Rate	Statutory Average Tax Rate
5	0.0	0.0
10	3.4	3.7
15	6.9	8.3
25	11.8	11.8
40	15.2	16.1
60	18.2	21.5
80	21.6	25.8
100	23.0	29.1
150	24.3	34.7
350	26.8	45.0
500	25.0	47.9
1,000	22.9	51.5

SOURCE: Derived from Internal Revenue Service, *1979 Individual Tax Model File and 1979 State Tax Model File*, and author's calculations. See text for details.

The statutory average tax rate increases steadily from 29 percent at $100,000 to 51 percent at $1,000,000, as it approaches its limit of 70 percent (in 1979). In contrast, the effective average tax rate increases little for incomes above $60,000. In fact, the effective average rate is virtually identical for taxpayers making both $100,000 and $1,000,000 in 1979.

This comparison underscores the difference between the intended and actual impacts of taxation when decision makers are sensitive to the rate of taxation. The actual redistributive impact of progressive taxation is reduced substantially when taxpayers respond to high statutory rates by increasing their tax-avoidance activities. Effectively the impact of the progressive rates on the distribution of the tax burden is not much different than what one would expect from a quasi flat rate structure with a much lower maximum statutory rate. When this problem is added to the previously discussed imprecision of annual income as a measure of economic status and the adjustment of markets to differential tax rates, it is clear that the egalitarian effect of progressive taxation is small.

VI. Progressive Taxation and Economic Inefficiency

While economic analysis indicates that the redistributive effects of progressive taxation are minimal, the inefficiency side-effects of

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the tax can be significant. As Adam Smith pointed out long ago, private and social interests harmonize when decision makers bear the full costs and reap the full benefits of their activities. However, problems arise when this is not the case. When individuals are unable to capture fully the benefits, they have less incentive to undertake productive activity—to help others in exchange for income. Thus, they engage in fewer wealth-creating activities. Similarly, when the costs of an action are, at least partially, foisted onto nonconsenting parties, individuals may undertake actions which they value more than their personal costs, *but less than the total costs of the action,* including the costs imposed on secondary parties. Such actions destroy, rather than create, wealth.

This is precisely the set of problems raised by taxation, particularly high marginal tax rates. When marginal rates are high, individuals have less incentive to make the sacrifices—to bear the risks, make the human capital investments, accept demanding jobs, and engage in activities that generate taxable income. Lawyers, doctors, and other high income professionals spend more time on the golf course and consulting with their accountants and less time serving their clients. Similarly, secondary workers decide that their job is not worth the hassle when they get to keep only a fraction of every dollar they earn. The harmony between private and social interests breaks down. Positive-sum activities are forsaken and wealth creation is retarded.

Simultaneously, high marginal tax rates encourage individuals to increase their expenditures on items that reduce their taxable income. Valuable resources are expended purchasing business and personal deductible items since, with high marginal tax rates, a sizable portion of the cost of such items is foisted onto others. Similarly, high marginal rates encourage investors to undertake projects that generate accounting losses while moving ordinary income into the future and transforming it into capital gains income. Higher rate of return projects generating taxable income will be forsaken in favor of tax shelter investments. The process wastes valuable resources and reduces the size of the economic pie.

Progressive taxation distorts the incentive to employ resources in their most productive or highly valued uses. The loss of real income associated with tax-induced changes in taxpayer behavior is real and thought to be quite large, but it is not reported in any budget. Therefore, why should policymakers care about (or consider) the excess burden of progressive taxation? The answer, of course, is that optimal policy requires all costs—direct and hidden—to be considered in

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determining whether government programs yield benefits large enough to justify their costs.

VII. Conclusion

Progressive taxation is a sacred cow. It is also one of those ideas that looks much better at first glance than it does when you delve into it. The philosophical case for it rests with egalitarianism, not some widely accepted tax equity principle. However, in practice, progressive taxation is not very egalitarian. Taxable annual income is a poor measure of economic status. Thus, the high rates are often levied on the wrong people—on dual-earner families rather than families with substantial nonmarket time, on the working poor during their prime years rather than the well-off retiree, and on the not-so-rich and temporarily well-off rather than the permanently well-off. To the extent high taxes do fall on those with high real incomes, predictably in the long-run, market adjustments will erode much of the intended egalitarian impact. A progressive tax may be able to reduce the rate of return (and after-tax earnings) from decisions that were made yesterday, but in a free society it will be difficult to seize the returns from *tomorrow's* investments, including labor supply choices. Predictably, decision makers will adjust in a manner designed to reduce the success rate of future fleecings. Their adjustments will lead to less supply and higher *pre-tax* returns and earnings for activities that are hit hardest by high tax rates. After markets have adjusted, the redistributive effects will be substantially more limited than static income statistics imply.

Finally, while the process does little to promote economic equality, we pay a dear price. Negative-sum games are encouraged and positive-sum activities are discouraged. A central principle of a free society that people are *entitled* to what they earn—what they acquire without the use of violence, theft, or fraud—is seriously tarnished. Our experience with a quasi-flat tax has been positive. The two decades following World War II were characterized by across-the-board economic progress.

Viewed from these angles, the case for progressive taxation is flimsy, at best. The case for high marginal tax rates, say combined federal-state rates in excess of 50 percent, is nonexistent. Perhaps the time has come to quit worshiping a sacred cow.

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ARE POLITICIANS INTERESTED IN HONEST TAX REFORM?

Dwight R. Lee

The paper by Professors Gwartney and Long (1985) is motivated by the view that our federal income tax structures can no longer be defended against any reasonable criteria. Our tax system is impossibly complicated, it fails all but the most ad hoc notions of fairness, and it grossly distorts economic decisions. That tax reform is a worthy objective is beyond serious challenge. Furthermore, the deficiencies in the current tax system are so obvious that little sophistication is required to suggest genuine improvements. Indeed, it does not seem particularly rash to assert that any intelligent eighth-grade student could formulate a tax system which, on the basis of simplicity, efficiency, and commonly accepted norms of fairness, would dominate our current tax system.

This is not to say that but little sophistication is required to fathom fully the problems arising from the way income is taxed by the federal government or to arrive at alternatives which satisfy all of the subtle requirements of economic efficiency. The Gwartney-Long paper is testimony to the sophistication required both to diagnose the ills afflicting the present system of income taxation and to prescribe detailed reforms for moderating these ills. Gwartney and Long see the major ills with the current federal income tax in the high marginal tax rates which an increasing percentage of taxpayers have been subjected to in recent years. Not only do these high marginal rates motivate blatantly inefficient decisions, but they fail to allocate the tax burden as intended, and they also fail to generate significant revenue.

I have little complaint with the Gwartney-Long diagnosis. However, their paper prompts the consideration of questions that go

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beyond the typical concerns over the efficiency and fairness of the current tax system relative to alternatives. Although criticism of the existing tax structures and flat rate tax proposals have been around for a long time, and have no doubt had some political influence, the swell of academic interest in tax reform is explained by the fact that genuine tax reform has finally been put on the political agenda in a serious way. Why this recent interest in real tax reform on the part of politicians?

It has long been known that economic efficiency could be improved, with no sacrifice in fairness, by shifting from a steeply progressive income tax structure to a flat rate, or modified flat rate, structure. Have politicians suddenly lost their immunity to the charms of general economic efficiency? This is doubtful. Benefits that are spread widely, as are those provided by general economic efficiency, have never excited politicians as acutely as have those which are concentrated on small but politically organized groups. And there are no reasons for believing things have changed. The sudden political interest in flat rate tax proposals cannot be explained in a way that really satisfies unless we begin from the premise that politicians, like other mortals, seldom see the public interest so clearly as when it corresponds with their private interests.

A convenient place to begin an explanation of the political interest in the flat rate tax is with the observation of Gwartney and Long that not all that long ago we, in effect, had a flat rate tax structure in the United States. The tax structure was decidedly progressive on paper, but close to 90 percent of those who paid federal income taxes in 1962 faced marginal tax rates from 20 to 22 percent. This situation presented a tempting opportunity to politicians. By increasing the effective progressivity of the tax structure politicians could increase tax revenue by supposedly shifting the burden to the wealthy, a shift that always sounds appealing to the majority. Finding that the best way to get rid of temptation is by yielding to it, politicians increased dramatically, through the use of inflation induced bracket creep, the real progressivity of the income tax during the 1960s and 1970s. But yielding to one temptation invariably brings to the fore new temptations. As the tax structure became more progressive, political merchandise in the form of tax breaks and loopholes became more valuable. With those facing high marginal tax rates willing to pay more for tax relief, politicians faced another temptation which broke through their facade of resistance and the federal income tax became entangled with loopholes.

Selling loopholes can be a profitable business for politicians, but it is not a business that remains profitable indefinitely. As more and

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more loopholes are sold, three things happen, all of which are unfortunate from the politician's perspective. First, most of the politically organized interest groups will have eventually purchased the tax loopholes and shelters pertinent to their businesses, and politicians will find the inventory of tax breaks running low. Second, the average taxpayer will soon begin suspecting that the tax system, no matter how progressive it may appear on paper, is placing most of the tax burden on the middle class, not on the rich. Finally, the tax system will become a less potent source of revenue than would one with more moderate rates but less permeated with loopholes. As Gwartney and Long point out convincingly, there has been an erosion in the ability of our income tax system to raise and redistribute income.

We have reached the point where most of the political advantage has been squeezed out of the progressive income tax. It is not surprising that politicians, just as anxious to capture wealth from the private sector as ever, have suddenly shown genuine interest in moving toward a flat rate tax. Talk of revenue neutrality notwithstanding, eliminating the escape hatches in the existing tax system appeals to the revenue enhancing instincts of our political representatives, even if it means sacrificing high, but impotent, tax rates. The broad gains in economic efficiency that can be generated by lower marginal tax rates, if realized, will be a by-product of narrowly motivated political concerns, and a *temporary* by-product at that.

There is no reason to believe that tax reform which reduces marginal rates will be permanent reform. Only the most trusting of political motivations can fail to recognize that a low rate tax structure with few loopholes will present politicians with a tremendous temptation. How long before "crucial" revenue requirements "justify" a "temporary" increase in the rates? How long before the political advantage of "making the rich pay their fair share" leads to more progressivity creeping back into the tax structure? And once rising tax rates increase the profit politicians can realize from merchandizing tax breaks, who can seriously believe that the tax system will not soon look much like the one we currently have?

This is not an argument against tax reform. After all, nothing lasts forever and it is clearly better to experience the efficiencies of lower and flatter taxes for a few years than never to experience them at all. But the perspective taken here does support an advantage the Hall-Rabushka proposal has over the other tax reform proposals, an advantage that seems to have gone unnoticed. One of the distinguishing features of the Hall-Rabushka proposal is that it is a true flat rate tax; everyone who pays positive taxes faces the same marginal tax rate. The efficiency advantage of a uniform marginal tax rate is obvious,

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and is indeed the ideal toward which all of the modified flat rate tax proposals move; political considerations are the obstacle that prevents these proposals from being true flat rate tax proposals. But it is also political considerations, particularly those suggested by the above discussion, which, quite apart from strict economic considerations, make a uniform flat tax superior to the modified version.

Simply put, reform that results in a single tax bracket will be a more enduring reform than one that results in multiple brackets. With a genuine flat tax any move to insert progressivity back into the system by increasing the rate within certain income ranges will constitute a clear violation of the reform. Therefore, such creeping progressivity is more likely to be attempted if the reformed tax system contains multiple tax brackets at the outset. Also, with it more difficult to add tax brackets, it will be more difficult for politicians to take advantage of the reformed tax environment (one with few legitimate ways to avoid taxes) by raising tax rates. The only way to raise tax rates with a true flat rate tax is to raise the tax rates on all taxpayers, a move that will meet with more political resistance than will tax increases on selected income groups.

Tax reform which produces an honest flat rate income tax will not only be better reform, it will also be longer lasting reform.

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SEMANTICS OF THE FLAT RATE TAX AND TAX REFORM

Joseph J. Minarik

Two of the most frequently used terms in economics and politics today are "flat rate tax" and "tax reform." Hardly a policy agenda appears that does not include one or both. Yet these terms mean different things to different people. The current imprecision may cause some confusion, and may delay and distract the political debate. An evaluation of the role of these concepts today might not get far beyond a definition of terms. This analysis will try to get at least that far, with a few subjective observations along the way.

What Is the Flat Rate Tax?

For a policy option whose hallmark is simplicity, the flat rate tax has become a surprisingly complex and slippery concept. The federal income tax has had graduated rates since its inception. Until World War II, the upper graduated rates affected only a few people—but so did the lowest rate, for that matter, because only a small minority of the population paid income tax at all. The rates themselves were quite low, except in the period during and immediately after World War I.

World War II brought the income tax to a majority of the population and pushed the highest marginal rates above 90 percent for the first time. The postwar buildup in strategic arms and the Korean conflict kept government spending high and required continuation of high tax rates. It was in the subsequent atmosphere of somewhat reduced tensions that the high and steeply graduated marginal tax rates, previously accepted in the spirit of wartime sacrifice, were first questioned.

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Pure and Practical Flat Taxes

To many, the connotation of a "flat tax" is something that is completely uncompromised; all income is subject to tax and is taxed at a single rate. That was not the form that the most prominent early flat tax proposal took. When Blum and Kalven (1953) raised their objections to "the uneasy case for progressive taxation," they proposed in its place what they called a "degressive tax," that is, a tax at a single rate on all income above some exemption or standard deduction. The exemption or deduction was included to avoid the ethical failing of imposing taxes on the poor (though there was no official definition of poverty at the time).

With the low-income relief of their degressive tax, Blum and Kalven introduced a certain arbitrariness into the flat tax concept. They admit that the appropriate size for the exemption or deduction is necessarily controversial. It is but a short step from the degressive tax to any number of variations that bear little resemblance to the traditional notion of a pure flat tax.

Modified Flat Taxes

In fact, the current tax debate has moved from the flatness of the billiard table to the finely drawn distinctions of a quality relief map. The issue is not flatness in absolute terms, but rather comparative degrees of flatness. Milton Friedman, a long-standing advocate of the flat tax, has himself argued for imposing a maximum marginal rate (usually 25 percent) at the top of the current graduated tax schedule (Friedman 1980). This would put a sizable minority of taxpayers into a single marginal rate bracket, but it would leave little of total income subject to tax in that bracket. Thus, it would be a flat tax at the margin for the few, but by no means a flat tax for the many.

After Friedman's suggestion, numerous analysts have tried other variations on the basic flat tax theme to achieve particular combinations of objectives. Of the prominent tax proposals currently on the table, only one—the Hall-Rabushka package introduced by Senators Dennis DeConcini and Steven Symms—could be described as a flat rate tax by even the very general definition of having a single tax rate. And even that proposal seems somewhat distant from the mainstream of policymakers' thinking at this time.

The object of most policymakers' affection now is the so-called modified flat tax (this term being an improvement of the prototype "progressive flat tax"). The modification, of course, is that the modified flat tax is not flat. Two of the proposals in this category, the Treasury's package of November 1984 and the "Fair Tax" proposed by Senator Bill Bradley and Representative Richard Gephardt, employ

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only three tax rate brackets (down from the current law's 14 non-zero rate brackets for married couples and 15 for single people), with the lowest bracket extending high enough on the income scale to accommodate upward of 70 percent of all taxpayers (Friedman's suggestion stood on its head). These proposals are flat taxes, therefore, for the majority of the population; but they both specify significant progressivity at the upper end of the income scale (with maximum rates of 35 percent and 30 percent, respectively). A third prominent proposal, the Kemp-Kasten "FAST Tax," has a basic tax rate of 24 percent, but allows a 20 percent exclusion of earned income up to the amount of the social security payroll tax wage base, phasing the exclusion out over the next roughly $60,000 of earned income. Thus, the Kemp-Kasten bill has what is in effect another three-bracket system, but in this case with the highest rate in the middle (where the earned income exclusion phases out).

The reason for the algebraic gymnastics in the Kemp-Kasten proposal, and the reason why the Hall-Rabushka proposal has not caught on outside of a relatively narrow circle, is simply that a single marginal rate of tax, whatever the low-income allowances, will significantly redistribute the tax burden. In particular, with low-income relief provisions anywhere near the levels of the current law, the single-rate tax will lift a sizable share of the tax burden from upper income groups and increase the tax burden for median income groups. Members of Congress and others have been reluctant to endorse approaches that would increase the tax liabilities of the majority of their constituents.

The only defense against these redistributive effects within the constraint of a single tax rate is to cut the yield of the tax (either by reducing the tax rate or increasing the low-income relief) until middle income taxpayers are held harmless. This leaves the federal government short of revenue, of course; it also gives upper income taxpayers even larger tax cuts.

Both the revenue loss and the upper income tax cuts have been denied by some advocates on the ground that there would be substantial supply-side increases in income and tax revenues on the part of these upper income taxpayers. Regardless of whether these supply-side effects would materialize, several factors must be kept in mind. First, the federal budget is now in substantial deficit. If a flat rate tax with a substantial revenue cost is enacted, and if the supply-side responses do not materialize, the short-term economic costs could be catastrophic, and the long-term costs would certainly be serious. Second, unlike the 1981 across-the-board tax rate cuts, a flat rate tax would reduce the marginal tax rate and thus enhance

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incentives almost exclusively for the upper income population; thus, the flat rate tax's supply-side leverage on the population as a whole would be less. Although the claims of supply-side responses to the 1981 law focus mainly on these upper income groups, it is clear that the responses, if they have occurred, have not yielded sufficient revenues to control the deficit.

In sum, there are no pure flat rate tax proposals (meaning a single tax rate and no relief to lower income groups) on the market today. This should not be surprising, nor should it be lamented; the tradition of the last 20 years of lifting the tax burden from the poor should be continued. The flat tax mantle, however, can easily be spread over such tax systems as the Hall-Rabushka proposal, but these systems have failed to hold center stage.

Should the modified flat tax, in its many incarnations, be considered part of this flat tax family? The 1984 Treasury proposal and the Bradley-Gephardt proposal are single-rate taxes for the bulk of the population. On the other hand, there are precedents from traditional tax reform for lower rate income taxes with many fewer brackets (for example, the Treasury's 1977 Blueprints for Basic Tax Reform had three income tax brackets). Thus, the parentage of the modified flat tax is uncertain, though there are apparent family resemblances from both the flat tax and the tax reform clans. If the lineage of the modified flat tax is subject to dispute, how do the two strains embodied in it relate to one another?

What Is Tax Reform?

As noted earlier, there has been an identifiable strain of tax policy analysis known as "tax reform" for some time. But in recent years, this strain has become even more confused than the flat tax concept. This confusion is due mainly to the differing values of various analysts and policymakers. In part, however, the confusion about the identity of tax reform is due to the political appeal of the term. According to one of the tongue-in-cheek "Ten Commandments of Tax Policy," "Whatever you want to do, call it reform." This section examines the subcategories of tax reform to see how the flat tax fits in. What is tax reform, and how does it relate to our recent policy debate?

Economic Income

Perhaps the most traditional strain of the tax reform school calls for the use of an economic measure of income. This strain points out the distinctions between the "true" income of taxpayers, including

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all accretions to their economic well-being, and the measure of income that is used for tax purposes. The earliest contributions to this school of thought were absolutely fundamental to the development of scholarly thinking on income taxation (Haig 1921; Simons 1938). It was this scholarly literature that led to the understanding of income for tax purposes as consumption plus the increase of net worth over a given accounting period.

Departures from the true measure of income are seen as harmful by this school of tax reform for at least four reasons. First, if some income is categorically excluded from taxation, recipients of that income are unfairly advantaged. Second, those who do not in the first instance receive their income in the preferred forms will be induced to move into the preferred forms of economic activity, thereby distorting the allocation of resources and reducing national income. Third, some taxpayers will try to take advantage of the tax preferences in an artificial way through legal and accounting devices, thereby complicating tax administration and eroding the integrity of the tax system. And finally, tax preferences result in lost revenue, thereby forcing tax rates up, dampening incentives for productive economic activity, and increasing incentives for tax avoidance and evasion.

The recent activity of this school of tax reform has been the measurement of the margin between economic income and income as defined for tax purposes (Pechman 1965; Pechman and Okner 1972; Minarik 1980). These measurements serve to identify the sources of divergence between economic income and income for tax purposes and to show the relative importance of these various sources. A natural outgrowth of these measurements is the ability to predict the growth of the tax base that would result if particular departures from an economic measure of income were eliminated. These results can be used to determine the tax rate reductions that could be allowed if the tax base were broadened in particular ways. The end products are schemes for tax reform in this traditional mold, typically involving substantially reduced marginal tax rates at a constant level and distribution of the tax burden (Pechman and Okner 1972; Minarik 1977). From the traditional tax reform point of view, the reduction in marginal rates is vital; the increase in incentives for productive activity and the decrease of incentives for avoidance and evasion rate almost as high in importance as the greater neutrality of the elimination of tax preferences.

Tax reform defined in this way clearly resembles the flat tax in its purest form. Similarly, with its emphasis on lower marginal tax rates, traditional income tax reform has much in common with the flat tax. Some conflict arises, however, over maintaining the distribution of

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the tax burden. The single-rate tax necessarily redistributes the tax burden from the most well-to-do to the middle class. This result is not determined theoretically, but rather empirically, from the degree to which elimination of existing income tax preferences increases the size of the tax base at different levels up and down the income scale.

Measuring Income during Inflation

The United States has endured substantial inflation since the genesis of the recent interest in the flat tax and tax reform. Economic research has increasingly emphasized the adverse effect of inflation on the measurement of income from capital. It is well known that inflation erodes the principal amount of fixed-income assets, leaving some of the interest receipts, in effect, to keep the principal value whole. Because all of the interest is taxed, however, taxable income exceeds real income; in fact, depending on the circumstances, the tax due can exceed the real income. Likewise, real capital gains are overstated when measured by nominal gains, because inflation erodes the purchasing power of the originally invested principal. Finally, depreciation deductions based on historical cost fall short of the replacement cost of physical capital assets when there is inflation.

There seems little doubt that inflation neutrality would be desirable in principle. The issue is how to attain it. Within the confines of the income tax, indexing the basis of capital assets is the only way. Owners of fixed-income assets would need to claim negative income each year, equal to the inflation-induced depreciation of the principal amount of their assets. Taxpayers who realize capital gains would claim an adjustment to the basis of their assets. Depreciation deductions would be adjusted for the increase of replacement cost due to inflation.

An alternative route is using an expenditure rather than an income base for the entire tax. Under the expenditure tax all purchases of capital assets would be immediately deductible as saving (as opposed to consumption, which is the base of the tax). Transition to an expenditure tax would be a complicated matter, however, with particular problems in dealing with the consumption of retirees out of prior fully taxed savings.

Some analysts have concluded that tax reform must include an indexation of the income base for inflation. That principle underlies the Treasury I proposal (1984). Other analyses stress the difficulty and complexity of indexing the tax code without leaving distortions greater than those caused by inflation. Moreover, any judgment on indexation involves an implicit forecast of future inflation. If prices

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are relatively stable, the costs of indexation may well exceed the costs of inflation in an unindexed system; with more rapid inflation, this comparison is certainly reversed (Aaron 1976).

The flat tax may or may not harmonize with indexation. Again, in principle, taxing real income is probably preferable, even though in practice indexation is extraordinarily complex, and may well clash with the simplification aspect of the flat tax. The Treasury plan confirms this problem. Rather than indexing interest income precisely, asset by asset, Treasury I opted for a simpler but imprecise rule-of-thumb approach. The complexity of true indexation was judged simply too great for the average taxpayer to handle. Complexity is a real issue for the average taxpayer, because over half of all tax returns report some interest income.

A further issue in indexation is interest expense. Just as inflation causes interest income to be overstated, it also causes interest expense to be overstated. Indexing interest expense is essential if interest income is indexed; otherwise, taxpayers can design combined borrowing-and-lending transactions wherein they pay tax on only real interest income while they deduct nominal interest expense, enriching themselves at the expense of the Treasury with no economic benefit to society. Indexing interest expense is not only complex; it is also painful. Borrowers, particularly those who borrowed at high, inflation-influenced interest rates, would be indignant at additions to their taxable income because of inflation's erosion of the real value of their debts. To avoid this political firestorm, Treasury I exempted all mortgage debt from indexation, thereby leaving a huge preference, perhaps even greater than the preference in the current law, for owner-occupied housing.

Whether a flat tax should be indexed is thus a multifaceted decision. Purists for taxation of real income would insist on indexation, while others might argue that nominal rates of return can adjust in the marketplace (particularly if variations in marginal tax rates from taxpayer to taxpayer can be significantly reduced) to achieve near-neutral results without the pain and complexity of indexing.

Marginal Rate Reduction

The traditional school of tax reform put great weight on elimination of preferential provisions in the tax law. In contrast, other analysts, most notably Milton Friedman and James Buchanan, have argued much more strongly for marginal rate reduction (Friedman 1980; Buchanan and Brennan 1980). The rate reduction argument centers on the likely behavior of taxpayers with respect to preferences under a regime of substantially lower tax rates. Traditional tax reform holds

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that taxpayers must be prevented from using tax preferences by repealing them from the law. When this is done, the tax base will be broadened, and marginal rates can be reduced without a loss of revenue. In contrast, the rate reduction school would hold that marginal rate reductions depreciate all preferences in the tax code. At marginal rates below some level, taxpayers would simply cease to use those preferences, because they would cease to be profitable at those lower rates. There would be no need to go through the pain of repealing the preferences in the tax code.

The productivity of the rate reduction strategy depends on the share of income that is now taxed at full rates and the degree of tax subsidy available for preferred investments. The experience of the 1981 tax rate cuts was not encouraging. The Accelerated Cost Recovery System (ACRS) and other tax preferences combined to make tax sheltering more, rather than less, profitable. The 1981 and 1982 Internal Revenue Service statistics showed that the entire partnership sector of the economy ran net losses for the first time in the history of the statistics (Piet 1983 and 1984). Given the rest of the tax code, the 1981 rate cuts were not enough to stop tax sheltering and its resultant waste of vital resources.

Could a deeper rate cut in a flat tax leave tax revenues whole without a rewriting of the details of the tax code? Experience cannot answer this question definitively. So whether the flat tax and this branch of tax reform are in harmony must remain a matter of opinion.

Targeted Subsidies

Another definition of tax reform runs almost directly counter to the traditional school, though it leans somewhat on the real economic income point of view. This definition would hold that tax reform is the provision of subsidies to activities that are important to economic growth. Thus, the enactment of ACRS or the expansion of the capital gains exclusion might be called "reform," even though they push the definition of income for tax purposes even farther away from true economic income (Bloomfield 1983). The rationale for this position in the case of income from capital may be that such income is mismeasured during inflation.

The problem with this definition of reform from the traditional view is that it requires outguessing the market—finding and subsidizing activities that would do more for the economy than those that would be selected by the unconstrained operation of the marketplace. This is a tall order for any individual or committee to achieve. Another problem is that whatever the intent of tax subsidies, they always create opportunities for manipulation and avoidance; some

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of the intended subsidy leaks into tax sheltering schemes, distorting resource allocation and demeaning the income tax itself.

Targeted subsidies and the flat tax would have a tense marriage. Lower rates would reduce revenue in the first instance, and if repeal of existing tax preferences were compromised by the introduction of new ones (or the retaining of selected old ones), the revenue cost could be prohibitive. If flat tax advocates were not satisfied with low and uniform tax rates on all of income, the entire concept would be open to question.

The Budget

There are two schools of thought concerning the budget. To some observers, the budget deficit is paramount. A tax change would be less than a reform if it failed to raise whatever additional revenue was necessary to reduce the deficit to a manageable size. That amount of revenue would be determined in a multipart political process, in which different categories of spending would be examined for politically acceptable and programmatically desirable cuts, and the tax system would be left to make up the difference. Whatever structural improvement of the tax system that could be had at that point would be welcome, but it would be the frosting on the cake in the larger view of things.

According to another point of view, the real issue is the total amount of government spending. Total spending is the real burden on the public, from this viewpoint, and the state of the tax system is at a lower level of concern. This view suggests that tax revenue cuts that force later spending reductions are a real fiscal reform, regardless of the tax policy consequences. Any government deficit that ensues while the public sector is cut down to size is a transitional problem at worst.

How the flat tax fits in this dichotomy is anybody's guess. Proponents of supply-side economics might see a flat tax as a deficit remedy, satisfying the antideficit school. Others might see a modified flat tax as the least distorting and least painful way to raise additional revenues under static economic assumptions. On the opposite side of the street, a low, single-rate tax might be a convenient way to cut federal revenue and force major surgery on the spending side.

Obviously, the deficit is a divisive issue, and when it cross-cuts the tax reform debate it leaves the body politic in a shambles. It is hard to say for certain how the many splinters of these policy positions will come back together, if at all. Public opinion certainly has moved toward a broader tax base and lower tax rates, but the trend is tenuous.

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We do not know what the flat tax really is, but we do not know what tax reform is either. The positive connotations of the word "reform" have made it a handy banner for just about any cause. Traditional strains of thought are divided on the appropriate distribution of the tax burden, the proper response to the problem of inflation, and the optimal size of the federal establishment. When the politics of the budget deficit compound these fractures, it is clear that there is no single strong limb to support the flat tax or any other tax policy concept.

Conclusion

This paper should confirm what just about everyone thought already: that the people identified with or supportive of the issues of "tax reform," "the flat tax," or other near-synonyms are far from a coalition, but rather constitute the most loosely knit group of traditionalists, supply-siders, budget cutters, and budget balancers imaginable. They all want economic growth, but they cannot agree on how much they should hope or plan for. They all want a sound fiscal policy, but their conceptions of what that means are all over the lot. They all want low tax rates, but they would cite reasons that are probably mutually inconsistent.

Whenever such a shaky consensus begins to congeal, the members have to ask themselves what really matters, lest the consensus dissipate just as suddenly. In this instance, some policymakers who want a broader tax base as a primary objective, and others who want lower tax rates first and foremost, have found themselves in the same uniforms. There will be the inevitable debates over who got there first and why; but those questions are for after the game. The real issue is where the common ground is and how the unlikely allies can fight together to achieve all of their objectives.

In my opinion, the elemental force behind the recent demand for a new tax policy is fairness—the public's desire for it, and the current tax system's lack of it. The public's complaint is not based on too much or too little rate graduation, though perhaps everyone has a notion of a preferred rate schedule. Rather, the public unrest is based on the current law's lack of integrity and certainty, on its willingness to be bought for the benefit of any group with a lobbyist, a lawyer, and an accountant. The public complains because it perceives that some people need not heed the broad outlines of the law. So long as the tax law does not treat all taxpayers in roughly the same way, it invites noncompliance and abuse, twisting the vicious circle one more turn.

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In 1981 the tax legislative process got caught up in a bidding war, with the two sides vying for support by offering a better deal to certain select interest groups. The result was not public satisfaction, but rather a public demand for something different. The same thing could happen again. The groups that had the political power to extract preferences from the current law could continue to press their interests, and the political process could respond to such claims. The result, however, would have the same fundamental flaw that has caused today's drive for change: the preferential treatment of a select few.

It is important that all sides of the flat tax coalition remember that the essential attribute of that tax is a connotation of equal treatment; the "flat" in most people's minds probably characterizes the proverbial playing field more than the rate schedule. A single rate with exceptions for today's favored groups will face the same public hostility as the current law. If the subject of tax shelters remains on the financial page of every daily newspaper, tax reform will have accomplished nothing. A flat tax, modified or otherwise, can reduce tax rates and budget deficits, and it can simplify forms and instructions. But it must command the respect of the taxpayers to be called "reform."

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THE PROGRESSIVE RATE–PROGRESSIVE REVENUE MYTH

Richard L. Stroup

The paper by Minarik (1985) provides a useful discussion of the array of flat tax proposals and of the various interpretations of "tax reform." However, while I found his paper informative, I must criticize him for being far too reticent about what we can say about tax rate impacts. We can go far beyond definitions and "a few subjective observations." As Gwartney and Long (1985) illustrate with econometric evidence, high tax rates can destroy a significant part of the tax base by driving people into tax avoidance activities. Nevertheless, Minarik seems to question the very existence of important incentive or supply-side effects stemming from higher marginal tax rates. He cites no evidence either way when he suggests that one opinion on these matters is about as good as another. I differ strongly with that judgment.

It is critical to note that a market economy is not a zero sum game—Lester Thurow notwithstanding. Market exchange creates value and facilitates specialization, which allows for greater production. In the words of Adam Smith, market exchange is the backbone of the wealth of nations. This is as true today as it was two centuries ago. When oranges from Orlando are traded for wheat from Montana, both the oranges and the wheat gain value, even if no extra oranges or extra wheat is created. But if profits from trading are taxed at 50 percent, less trade will occur.

Higher taxes make trade less attractive and interfere with economic coordination, which can be described as a form of social cooperation. Self-centered activities, being untaxed (hiking, sport fishing, and other "leisure" pursuits), increase at the expense of market activities oriented toward what others might like from us. Our time, our land, our firms are devoted more to activities that please us and less to

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producing value for (and taxable payments from) others in society. Higher tax rates also mean greater tax avoidance activities, so that resources are devoted by taxpayers to avoiding taxes and by government to limiting tax avoidance activity. GNP falls and we are all poorer due to this "excess burden" of higher tax rates. Gwartney and Stroup (1982a) document the large impact, over the decades, that tax rate changes have had on tax avoidance activities.

We can also say far more about the equity impacts of higher tax rates than Minarik chooses to address. The rising tax rates imposed on people already in high tax brackets will shift the burden of taxes in a counterintuitive fashion toward lower income taxpayers. Again, the results of Gwartney and Long (1985) are pertinent. In their study they do not even look at the impact of taxes on gross earnings, but merely at the games people play in converting gross earnings to (a much smaller) net taxable income. At higher tax rates, more tax avoidance games make sense for the individual. But flattening the tax rate structure (lowering the top marginal rates) reduces people's incentive and willingness to undertake costly and complex tax avoidance activities.

Table 1 illustrates how lower tax rates can in fact increase the tax base by so much that revenue actually increases after a tax cut, for upper income taxpayers.[1] The figures from the Kennedy tax cut of 1964 demonstrate the expansive effects on economic activity of a tax

TABLE 1

REVENUE EFFECTS OF THE KENNEDY TAX CUT

Income ($000s)	Marginal Tax Rate Joint Return Top-of-Class Income 1963	1965	Percentage Rise in Adjusted Gross Income	Percentage of Tax Revenue Collected 1963	1965
Under 10	26	22	1.0	48.1	39.9
10–15	30	25	33.0	19.6	21.6
15–50	59	50	32.3	21.1	23.5
50–100	72	60	43.3	6.1	7.4
100–500	91	70	52.1	3.9	5.6
500–1,000	91	70	67.3	0.5	0.8
Over 1,000	91	70	71.6	0.7	1.2

SOURCE: U.S. Department of the Treasury (1963, 1965).

[1]Table 1 is adapted from Gwartney and Stroup (1982b).

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cut, and the counter intuitive shifting of the tax burden brought about by an across-the-board tax cut. Of course, by themselves, these numbers are only suggestive. But when combined with figures from other tax cuts, and with the Gwartney-Long cross-sectional results, they are convincing.

The 1964 tax cut reduced everyone's marginal tax rate (tax bracket) by about 22 percent. The cut was roughly uniform, but the effects were not. To see why, it is helpful to look at both the top and the bottom tax brackets. The top tax rate of 91 percent was dropped to 70 percent. But this 22 percent reduction is not the important part of the picture from a taxpayer's point of view. The taxpayer is interested in his take-home income, that is, his income after taxes. For taxpayers in the top bracket, take-home pay from earning another dollar rose dramatically: far more than 22 percent. Before the cut, the taxpayer in the top bracket could take home only 9 cents of an additional (taxable) dollar. But after the cut, the 9 cents figure became 30 cents—a 330 percent increase in the incentive to earn another dollar. By contrast, even though the bottom tax bracket fell from 20 percent to only 14 percent, the change in incentive was rather minor: 80 cents in take-home pay rose to 86 cents, from an additional dollar earned. That was only an 8 percent increase in the incentive to earn another dollar, even though the tax rate itself had been decreased by more than 22 percent.

We can see now why a flatter tax rate structure would substantially increase economic growth, raise more revenue, and in all likelihood redistribute the burden of the income tax, with the rich shouldering more of the load. The burden of the existing, highly progressive tax rate structure is not only very great, it puts a much greater burden on the low income taxpayer than would first appear likely. Again, Table 1 is instructive. Despite the apparent shift of the burden, giving many more dollars in tax breaks to the rich than to low income taxpayers, the rich in fact paid much more in tax revenues after the Kennedy tax cut than before it. Those earning a million dollars and up paid 70 percent more in taxes than before, while the bottom half of all taxpayers paid much less. Given the dramatic shift in incentives faced by the rich, as compared to the small change in incentives facing lower income taxpayers, we should not be surprised.

Buchanan and Lee (1982) have pointed out that these supply-side incentives can be expected to have much greater impacts in the long run than in the short run. Gwartney and I have elsewhere looked at the short-run impacts of tax cuts in the 1920s and 30s, as well as the 1960s, 70s, and 80s (Gwartney and Stroup 1982a, 1982b). All of the short-run effects are roughly in line with the substantial, and at first

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surprising, effects shown in Table 1. However, the long-run effects are even more dramatic. In 1926, after the Mellon tax cuts, the top rate was only 25 percent. That rate applied to people earning over $100,000. With a top rate of 25 percent, those individuals contributed 50.9 percent, more than half of all tax revenues in 1926. (Before the Mellon cuts, in 1921, people earning that amount faced a 73 percent marginal tax rate, and contributed 28.1 percent of all revenue.) But note that by 1963, the top tax rate had been driven all the way up to 91 percent. Did tax revenues increase from those individuals whose tax rate had risen so much? Emphatically not! Per capita GNP had nearly quadrupled from 1926 to 1963, so that we might expect far more income to those earning the same $100,000 per year (not corrected for inflation). Yet individuals earning over $100,000 in 1963 contributed only 5.1 percent of total tax revenues. At the much higher tax rates, interest groups had developed numerous tax loopholes over the years. The very rich were taxed at much higher rates, but paid less than one-tenth as much revenue.

When the top rate grew from 25 percent to 91 percent, the take-home pay from earning an extra dollar dropped from 75 cents to 9 cents. It does not take a genius to see that when the incentive to earn a dollar falls from 75 cents down to 9 cents, the incentives are dramatically changed. Moreover, there are a great many results of these incentives: activities with bigger payoffs include lobbying for loopholes, hiring tax consultants, taking tax deductible business-related vacations, engaging only in those money-making activities that are fun, and in general enjoying more perquisites that are tax deductible and taking fewer perquisites that must be purchased from after-tax income. The primary activity whose payoff declines when tax rates rise so steeply is profitable commerce. Fruitful exchanges in the marketplace are the main way in which people cooperate. Yet when the government takes 91 percent of the fruits of cooperation, one can safely predict a dramatic reduction in that kind of cooperation. In its place, strictly self-serving activities will thrive. Recreation, hobbies which can be pursued as "businesses," and tax avoidance of all sorts will increase.

Minarik seems to ignore the huge incentive differentials implicit in reducing the highest tax rates, and to ignore the predictable and observed tax revenue results. Consequently, he seems to ignore the toll that higher tax rates take on human cooperation. This, in my judgment, is a tragic mistake. Higher tax rates reduce economic exchange, destroy the tax base, and shift the burden of taxation toward low income taxpayers. To ignore the data examined in the studies cited above, as Minarik does, simply perpetuates the myth that a

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more progressive tax *rate* structure leads to a more progressive *revenue* result. Policy based on that myth is disastrous. In short, Minarik's paper does not take us very far. We clearly can say a good deal more than he is willing to say about the results of a flatter tax structure.

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THE ECONOMICS AND POLITICS OF TAX REFORM

Richard Gephardt

Introduction

Politicians have talked about tax reform forever. Everybody is for it, but most also have this or that little exception—the little deduction that they do not want you to touch. While there is a lot of interest in talking about tax reform, I am not sure how much interest there is in actually doing something. When you do something, there must be a specific proposal that actually says, "these deductions are in and those are out, and this is the rate structure."

It all really reminds me of a story I recently heard about a fellow in a particular town who was having great luck fishing. He was coming home with garbage buckets full of fish. It became an item of discussion throughout the county and much of the state. There were newspaper articles about it. Finally people talked about it to the point that the local game commissioner decided he had better investigate how in the world this person could be so lucky. So the commissioner began to investigate, to talk to people, trying to find out what kind of lures the fisherman was using. When the commissioner was walking down Main Street of the fisherman's home town, this fellow came up to him, hit him on the shoulder, and said, "I know why you're here and I have nothing to hide. In fact, the best way for you to find out how I do it is to go fishing with me."

The commissioner thought, "Well, this is the fastest way to find out." So they got in this fellow's car, went out to the local lake, jumped in the fisherman's boat, and raced out to the middle of the lake. The fisherman shut off the motor, reached under his seat, pulled out a stick of dynamite, lit it and threw it into the water. A huge explosion

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took place and a host of dead fish came up to the top of the water. The fisherman pulled out the garbage can and started throwing the fish into the can. The commissioner could not talk for about five minutes. Finally he regained his composure and he said, "Sir, do you realize you've broken every law and every regulation in the county and state game code? When we get back to shore I am going to take you in front of the magistrate and have you indicted."

The fisherman disgustedly dropped his bucket, reached under his seat and grabbed another stick of dynamite. After lighting the dynamite, he handed it to the game commissioner, and said, "Commissioner, are you gonna talk or are you gonna fish?"

I think this is exactly where we are with tax reform. We have about talked it to death and now it is time to get on with the really hard part—putting together the legislation and trying to pass a good bill. Before I discuss the mechanics of how this can be done and offer a political overview of where we are (which probably is the thing I am best qualified to discuss), I would like to present the basic rationale for tax reform.

The Rationale for Tax Reform

About eight years ago I was appointed to the House Ways and Means Committee, and I quickly learned how the tax game in Washington works. By 1977, for a variety of reasons, there were a significant number of entitlement programs in place. Defense, as you know, was increasing 4–5 percent a year above inflation. The only place we politicians could find to spend money was the place that nobody noticed—the tax code. In addition, we had inflation driving people into higher and higher tax brackets. Thus, with each passing year we had a little more revenue coming in. The percentage of the GNP the government was taking was rising. Deficits were not too bad at the time. So a favored activity was to get into the Ways and Means Committee and erode the base on which taxes were paid. Different groups of individuals were handed tax breaks, tax goodies, loopholes, incentives, or whatever you want to call them. In essence, what was taking place was a forgiveness of taxation in return for a change in some kind of behavior. As time passed, what started as a fairly isolated activity became a very popular political game. And as it increased in magnitude, more and more groups figured out how the process worked. The thinking was, if it was good enough for this and that industry, then surely we can work out a little something in the tax code for other favored groups.

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Many times these tax breaks were not major or highly publicized. One word in section 642Q was changed and nobody knew what happened, except some tax lawyer or member of the Joint Committee on Taxation. All of a sudden somebody or some industry picked up a couple million dollars or more because of some perverse, arcane change in a couple of paragraphs or a comma that provided yet more relaxation to the tax code—and another erosion of the base. As a result, each tax bill got bigger and bigger, in terms of complexity and in terms of forgiven revenue. I am told that about 20 years ago we had almost $37 billion worth of tax expenditures while today it is up to around $350–$360 billion.

The biggest program in the government is not defense or social security; it is a program called "tax breaks" or "tax incentives" and it is administered by the Internal Revenue Service (IRS) through voluminous regulations—written by the IRS, tested by the tax courts, and then rearranged and redone by Congress.

Having watched this process both from a tax policy standpoint and from a political standpoint, a number of us in the Congress became convinced that we had to have substantial change. We could not allow this process to continue—not just because of the economic effect or the complexity effect, but because people's faith in the tax code and in the government itself was being eroded. Thus, we began to investigate how these problems could be addressed—how substantial reform in our tax laws could be accomplished.

The Bradley-Gephardt Plan

In 1977, William E. Simon, then secretary of the Treasury, put out a thick new book called *Blueprint for Basic Tax Reform*, which basically called for a consumption-type income tax. The plan received considerable attention in Washington and generated significant debate, but it never resulted in a bill. When Jimmy Carter came to Washington in 1977, he came with his version of tax reform, which was basically the $50 rebate, prohibition of the three-martini lunch, and a few other odds and ends. It was an exercise in which he was trying to restore the tax base without any change in tax rates. It was not until after the 1981 tax legislation, which lowered the rates but failed to restore the base, that people seriously began to look at far-reaching income tax reform.

When I started my investigation, I actually began with a consumption-based income tax. Although attracted to the economics of the idea, after looking at it, talking to people about it, and working with the Joint Committee on Taxation, I came to the conclusion that it

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was both too complicated in terms of transition and too questionable in terms of its actual economic impact. I finally returned to the usual investigation of how we can take what we have, try to simplify it, and restore the base while lowering the rates. It was against that background that I came to know Senator Bill Bradley, who was engaged in the same activity. So we joined forces and came up with the Bradley-Gephardt "Fair Tax" bill.[1]

The Bradley-Gephardt bill has three basic objectives, the most important of which is to stimulate the growth of our economy. This is probably the most difficult goal to communicate. It is the one that people quickly want you to have eight econometric models to support. I do not have any econometric models, and I do not believe they would actually prove anything anyway. However, my gut feeling, common sense, and experience tell me that the American economy would work better if we had greater efficiency in our tax code—if we paid greater attention to the economic consequences of taxes for all kinds of capital and business decisions, rather than driving everything by an overwhelming and consuming interest in how the intricacies of the tax code treat specific activities. I cannot prove that to you—there is no way to prove it without trying it and seeing what happens—but I am convinced it is true.

The Argument for Efficiency

The main argument for tax reform, I believe, is to achieve greater efficiency in the way the tax code works. When Congress gets into the business of figuring out $370 billion of tax breaks a year, the House Ways and Means Committee and the Senate Finance Committee really are put in the business of trying, at least partially, to plan the American economy. We in Congress take pride in the free market system and do not want the government in the business of planning economic decisions. Nevertheless, the places we most often do that is in the House Ways and Means Committee and the Senate Finance Committee. I confess that I am not qualified to act as a central planner and I do not know anybody on either committee who is. They are all wonderful people, great Americans. They all mean well. But the fact of the matter is that when the details are all put together, I am convinced that we do not have the foggiest notion of what we are doing in terms of the total economic outcome.

The Congress has put provisions in the tax code that have deterred Americans from saving. As a result, our net private savings are relatively small. When government is borrowing 70 percent of those

[1]See Bradley (1984), Bradley and Gephardt (1985), and Gephardt and Wessel (1985).

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savings, as it is today and probably will be for the foreseeable future, the question arises, "Are we allocating the capital that is left in the private sector in the best way?" In my judgment we will have the best chance to do that if we get out of the business of trying to direct those decisions through tax laws.

The Argument for Fairness

The second objective of Bradley-Gephardt is to establish a fair tax system—to restore the tax base and to lower tax rates. Some people are worried that a flat rate tax will help people at the top of the income pyramid and that with fewer exemptions, the middle class will be disadvantaged. Senator Bradley and I are very concerned about the fairness issue. There are studies that indicate our bill would increase tax collections from people at the top end. There are others that disagree with this view. I think probably this disagreement results from different assumptions about how individuals adjust their consumption and investment decisions in response to lower tax rates. We asked the people who wrote our bill to try to make as sure as is humanly possible that we would not increase the tax liability of any income group. We believe that even with a static measurement of income, this has been accomplished.

I believe that our plan promotes fairness by the very fact that it increases the base and lowers the rates. Under our plan, people will be brought back into the tax system. I do not see how any of us can justify people's avoiding taxation—even with the minimum tax law that is now in place—because they are able to use all kinds of different shelters and mechanisms to get their effective tax rates down to very low levels.

On the corporate side, I really do not believe that we can argue that some corporations should be paying the top rate while other corporations should get a check from the government every year to stay in business. Yet this is essentially what we are now doing. We do not want to change the mix between the amount of tax corporations are paying and the amount individuals are paying. There are some people who believe that corporations, which now generate 6 percent of federal tax revenue, should be back to 15 percent. Others would like to take them to 25 percent of income. There are obviously others who believe that the corporate tax is an anachronism—that the economy would work better if we got rid of it. They say that even 6 percent is too much.

I have heard the corporate tax debate for eight years and we will hear it for the rest of our lives. I do not really think we ought to lower the corporate tax because people who believe corporations ought to

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pay some taxes are really going to get offended. However, we will all benefit if we can get corporations to pay more evenly in terms of what they earn. Thus, rather than trying to figure out exactly what percentage corporations should pay, we should attempt to achieve greater equity by treating corporations earning roughly the same income equally under the tax code.

If we are going to pass a tax reform bill, we desperately need to avoid the distributional debate. Some people want taxes on individuals to be more progressive. Some want them to be less progressive. The Bradley-Gephardt plan takes the position that if you keep progressivity about where it is with a static model, knowing that we are never going to agree on a dynamic model, then we will be okay. People can live with that and understand that it is a good outcome.

The fairness issue is an awfully important issue. Every poll shows us and every conversation with John Q. Public tells us that the American people, whether right or wrong, believe that the current tax system is unfair. There is a whole variety of reasons for that perception. However, the long and short of it is, if substantial tax reform is to occur it must achieve greater tax equity.

The Argument for Tax Simplification

There are all kinds of arguments about the tax simplification objective, and I admit that the transition rules will be something to behold if tax reform is actually implemented. The IRS and others will be kept busy for a very long time. But even admitting all the transition problems, we will strike a blow for simplicity by enacting any one of the plans that are currently on the table. There are two major reasons this is so. First, even with the transition rules, tax simplification will stop the constant meddling with the tax code, itself an important objective. Of course, nobody can guarantee that future Congresses will not tamper with a flat rate tax system that achieves the simplicity sought by the Bradley-Gephardt plan and other tax reform proposals. A new Congress convenes every two years. We send new members. Some of us get retired without wanting that to happen. New people show up and they come with new ideas and they want to change laws. There is no way we are going to stop or should we stop new Congresses from being able to change the law. However, I believe that if we can lower marginal tax rates and simplify the present system, the American people will be sensitive to any future attempt by Congress to erode the base and raise rates. Also, with two or three rates rather than with fourteen, inflation will have less of an impact. It will not drive people forever into the higher brackets, a phenomenon that encourages Congress to give goodies

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away by eroding the tax base. I really believe our plan will stop the constant churning and changing of the tax laws.

Second, if we can achieve tax simplification, many of the special exemptions and deductions can be abolished. The last tax bill Congress passed—the Deficit Reduction Act of 1984—was 1,300 pages long. It was a so-called loophole closing bill designed to raise revenue. When the regulations are completed, if they ever are—five or ten years from now—they will be another three or four or five thousand pages. It looks like what we are really trying to do is write a code for each person in the country. It is called mix and match—put together your own code. And when we get done writing provisions that we think apply to everybody in the country, we find out some people are slipping through the provisions. We go through the tax courts for 10 years and then we write some new regulations. Then we write a new statute and before we are done with one section that started out to be very simple, it turns out to be an absolute labyrinth of new tax rules and regulations. If we take out a lot of these deductions and we keep them out, and if we keep rates down, over time there will be a marked increase in the simplicity of tax law application. The IRS now audits less than 1 percent of all returns. It used to audit 2 percent. Part of the reason it cannot do better is the incredible amount of complexity involved in an audit of any return today.

In sum, the Bradley-Gephardt bill promises significant tax reform. If enacted, it would produce a tax system that is fairer, simpler, and more efficient than the current system.

The Political Landscape

Any discussion of tax reform must consider the political landscape: where we are, how we can achieve meaningful reform, and what the post-reform system is going to be like. This is somewhat like describing World War III because that is what it is going to be like to pass significant tax legislation. I have been through five tax bills and I have seen the lobbying pressures that have been brought to bear over little things that you would not expect anyone to quarrel over. Everyone remembers the fight over withholding on dividends and interest a couple of years ago. Every year we have looked at the tax law there has been an entry from the Joint Committee on Taxation and the treasury saying we ought to begin withholding on dividends and interest. Everybody got a good belly laugh out of it and then we went on to the next thing. I shall never forget when the withholding recommendation finally came up on the list of ways to raise revenue or to lose revenue. In 1982 Senator Dole and Congressman Conable

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and others decided that withholding on dividends and interest should be included in a tax bill. They argued that we had been talking about withholding for 20 years and that it made eminently good sense. Hence, they included it in the bill, which was signed by the president.

The banking industry said: "We know the president wants this bill, we have to do something about the deficit, and we will look the other way while you put it in. But we are making no commitment that we will leave it alone after it gets in." At the time I thought, "Boy, they made a terrible mistake because once it gets in they'll never get it out."

About a month after it was signed into law we started to see a few letters coming in—a sprinkling of letters from around our districts. Most were form letters, although they appeared to be individually written. All the sender had to do was sign it to send the message, "I want you to repeal the changes on the withholding of dividends and interest because I think it is unfair to tax my dividends"—something to that effect. What started as a sprinkling of letters became a heavy snowstorm and then a blizzard. In that year the number of pieces of mail to Congress went from two million to four million. At least two million were the prearranged mailings—mailings through savings and loan associations and banks. Every time they sent a statement to anyone, they would enclose a form letter and ask the recipient to mail it to his or her congressional representative. Some of them even included the 20-cent stamp to send it.

I remember saying, "You know, this is ridiculous, the people just do not understand this thing. We can educate people. We must stand behind this. The worst thing in the system is that people are not paying their taxes. This withholding thing is an absolute hemorrhage in taxes that are not being collected."

Then I remember going to town hall meetings and seeing attendance increase. We used to have 30 to 40 people wander in. Now I would go to a meeting and there would be 200 to 300 people there. Most of them were senior citizens. They would stand up and tell me how angry they were. I clearly remember one meeting when a woman stood up and said, "Why do you want to tax my dividends by 10 percent? Why do you want to raise the taxes on my dividends and interest?" I said, "Ma'am, I appreciate your concern, but this is not a new tax. It is simply a different way of collecting the tax. There is a big exemption provision and you probably will not be subject to withholding in any event." After I got through with the explanation, she stood up and said, "I appreciate what you said, but you did not answer my question. Why are you increasing taxes?" Everybody

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clapped and people stood on their chairs. I finally gave up, realizing that I could not get the point through.

This story illustrates the political impact of the tax law. There is no place where the intersection between the people and the government is as important as in the area of taxation. This is where the people meet their government. This is where everybody is involved with the government on an annual basis, sometimes on a quarterly basis—when they fill out their tax forms and send in their money. So if you are talking about substantial tax reform, you are talking about a political explosion the likes of which none of us has ever seen. There is not a lobbyist in Washington today who has not been hired by at least one group or organization to fight this tax bill. There are planes coming in and out of Washington with increasing frequency. The battle lines are drawn. It will be the political battle of the century if not the country's history. If it is to be won for tax reform, it will happen only if there is a genuine uprising by the people—something like the Boston Tea Party. People must say "I want it to change. I want you, my representative or senator, to vote against all of this clamor of special interests in favor of the general interest." It has to be put that starkly and it has to be put that bluntly in order to make it happen in Washington.

There are some good signs that make me believe it can happen. First, we appear to have a president who believes in tax reform, who wants it to happen and who will support it strongly. Second, we have bipartisan support in both the House and the Senate. Right now people favor different plans, but in essence the plans are very much the same. Third, I think the Congress in general understands the need for tax reform. There are many people who have debated tax reform measures and talked about changing the system for two or three years now and who have taken strong positions for tax reform. If we get something on the floor, I think we are going to have to confront it and vote up or down. Are you for it or are you against it? It is going to be a very important vote. So I am optimistic about what can be accomplished.

Concluding Remarks

Tax reform is really a choice about ourselves. It is a choice about our country. It is a choice about what kind of a tax system we deserve. And it is a choice that we ought to go ahead and make in 1985. If this debate goes on into 1986 or 1987, it will dissipate. It will drive business people crazy because they will not know what is going to happen; there will be no certainty, no predictability. It will wear

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people out, dismay them, and cause them to lose interest. We really ought to go ahead in 1985 and do it. Further, if we put it off to 1986, that will be an election year. You will have 22 Republican senators up for election. You will have about half that number of Democrats. There will be a huge fight for control of the Senate and control of the House. In such an environment, tax reform will come to a complete halt. It has to move in 1985 or it is not going to move. This is the year of decision.

The struggle for tax reform is really a test of whether self-government works. The whole idea of trying to run this country in part by a committee of 535 people is audacious when you really step back and look at it. With a population of 250 million people, we have a committee of 535 people trying to decide how something as complicated as a tax system should work. I really think it works only if, from time to time, we arrive at a consensus in our democracy that says, "What we have got here is not working. We need to return to something that will be more effective."

When Ben Franklin was leaving the building where they were writing the Constitution, he was asked by a group if we had decided to have a monarchy or a republic. It was an important question. He was happy to report to the group that we had decided to have a republic. However, as he walked on, he stopped and said, "My friends, we have a republic if we can keep it." That statement has been true every day since then and it is true today.

I believe part of "keeping it" is being willing to accept the challenge as Americans of debating and deciding what kind of tax system we want. It is the most important way Americans approach their government and have to deal with their government. Indeed, I believe that if our republican form of government is to survive and prosper, we must institute a tax system that is simpler, fairer, and more efficient than the present system.

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THE ROUTE TO A PROGRESSIVE FLAT TAX

Robert E. Hall and Alvin Rabushka

Introduction

The tax-reform movement, in its current phase, came to life in 1982. Our role in the movement began with an article we wrote for the *Wall Street Journal* on December 10, 1981, in which we first proposed our flat rate tax. The public, media, and politicians latched onto the idea of radical simplification and reform of the federal income tax, making it the most widely discussed national economic issue of 1982. Members of Congress rushed to introduce more than a dozen flat tax proposals. Some were pure, tithe-like, 10 percent flat tax rates on all income, with no deductions of any sort permitted. Others were so-called modified flat taxes with two, three, or four tax-rate brackets and sharply diminished deductions, but retaining the more popular ones such as home-mortgage interest and charitable contributions.

Today there are four main contenders, which have received the bulk of publicity and analysis and are likely to remain the chief alternatives to the current tax system. The most publicized plan is that of the U.S. Treasury, put forward in November 1984. Democratic Senator Bill Bradley of New Jersey and Congressman Richard Gephardt of Missouri are sponsors of another well-known proposal. They call their plan "the fair tax," which is also the title of Bradley's recent book. The chief congressional rival to Bradley-Gephardt has been proposed by Republican Congressman Jack Kemp of New York and Senator Bob Kasten of Wisconsin. Its acronym, FAST, stands for "fair and simple tax." It has the semiofficial blessing of the Republican establishment.

Our own plan continues to draw attention, though it is offered as an ideal, rather than as a politically practical compromise. It is

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pending in Congress in the form of a bill introduced by Senators Dennis DeConcini and Steven Symms. Details are available in our new book, *The Flat Tax.*

Virtually all participants in the modern tax-reform movement are concerned about improving incentives by limiting tax rates. Congressman Gephardt has acknowledged his conversion from purely distributional concerns to restoring incentives, noting that "since we are all supply siders, I think it is worth mentioning that our plan contains a very substantial work incentive."

It is abundantly clear that any serious reform of the income tax must embody two features: it must broaden the tax base and it must sharply reduce the high top marginal rates. It should make evasion uneconomic, undesirable, and harder to get away with. Participants in the underground economy should find it more attractive to surface. Tax shelters must become less enticing. In short, individuals and business firms must find earning higher incomes (and keeping most of each dollar) more attractive than saving taxes (now often 50 cents on each dollar).

The Hall-Rabushka Proposal

Not all ideas about the flat tax are the same. Our proposal sometimes suffers by association with proposals that are not progressive or do not take the problem of investment incentives seriously. In a nutshell, our flat tax proposal puts a tax of 19 percent on all consumption above a generous exemption ($12,600 for a family of four). It is progressive where it counts most, for the poor and near-poor. It has strong investment incentives because a consumption tax, by definition, puts no tax on investment.

Our proposal takes advantage of the administrative convenience of the value-added tax. The VAT is the most reliable way to put an airtight tax on all consumption. Investment incentives in the VAT are straightforward and comprehensive: All investment spending is expensed. The cumulative effect of a tax on value added with first-year write-off of investment is to put a tax on consumption. Such a tax provides the degree of investment incentive most widely recommended by economists.

The VAT in its usual form is not a satisfactory national tax because it is not progressive. If a tax were built in to everything purchased by all families, including the poor, it would be an unjust burden on lower-income families. In particular, a switch to a VAT from the current system would dramatically shift the burden of the tax toward lower incomes.

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Our proposal modifies the VAT in one central way: Under a standard VAT, the part of the tax that applies to wage earnings is paid by business as part of the overall VAT (in fact, this part is a large fraction of the total). In our modification, the tax on wage earnings is paid by the worker instead of the business. The worker can take a generous exemption, based on family size, against wage income before applying the 19 percent tax. As a consequence, our version of the VAT is strongly progressive for low and middle incomes. Even families earning $25,000 pay an average tax rate less than half the 19 percent paid by the highest earners.

Our two tax forms (illustrated in Figure 1) are almost self-explanatory about the details of the system. People who are not involved in operating businesses just fill out Form 1. Only their wage, salary, and pension income is taxed. Businesses of all types (not just corporations) fill out Form 2. The two forms together put a 19 percent tax on value added, with full write-off for investment and the exemption to make it progressive.

At every level of earnings, our Form 1 has a lower tax than does the existing Form 1040. Families who derive all of their incomes from earnings will gain from a switch to our system, no matter what their level of earnings.

One of the most important features of the VAT, shared by our system, is its ability to control leakage in the tax system. An important type of leakage today comes from interest payments. Interest is business income that is taxed as it is earned at the business under a VAT. But in the current tax system, interest is allowed as a deduction for the payer and is not taxed until and unless it is declared as income by the receiver. Through a great variety of means, legal and illegal, over $100 billion in interest is deducted by businesses but never taxed as income for individuals. A VAT is an airtight solution to the problem of interest leakage.

We see our proposal as setting a high but practical ideal for tax reform. It really would be possible to have a 19 percent tax on a broad base that is progressive, has strong investment incentives, and raises the same revenue as the current system. Of course, we recognize that the political system may grind out a tax improvement that falls short of our ideal. We will discuss briefly some modifications of our proposal that preserve its most important features. Later, we will look at the problem in the opposite way—how other proposals could be improved by modifications incorporating our ideas.

First, we have developed a transition proposal to handle the problem of lost interest deductions. Without loss of revenue, the government can permit people already committed to fixed interest rates to

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FIGURE 1

HALL-RABUSKA SIMPLIFIED FLAT-RATE TAX FORMS

Form 1 **Individual Wage Tax** **1985**

Your first name and initial (If joint return, also give spouse's name and initial)	Last name	Your social security number
Present home address (Number and street including apartment number or rural route)		**Spouse's social security no.**
City, Town or Post Office, State and ZIP Code	**Your occupation ▸**	
	Spouse's occupation ▸	

1 Wages and Salary	1		
2 Pensions	2		
3 Total *(line 1 plus line 2)*	3		
4 Personal allowance			
(a) ☐ $9000 for married filing jointly	4(a)		
(b) ☐ $4500 for single	4(b)		
(c) ☐ $8000 for single head of household	4(c)		
5 Number of dependents, not including spouse	5		
6 Personal allowances for dependents *(line 5 multiplied by $1800)*	6		
7 Total personal allowances *(line 4 plus line 6)*	7		
8 Taxable wages *(line 3 less line 7, if positive, otherwise zero)*	8		
9 Tax *(19% of line 8)*	9		
10 Tax withheld by employer	10		
11 Tax due *(line 9 less line 10, if positive)*	11		
12 Refund due *(line 10 less line 9, if positive)*	12		

Form 2 **Business Tax** **1985**

Business Name	Employer Identification Number
Street Address	**County**
City, State and ZIP Code	**Principal Product**

1 Gross revenue from sales	1		
2 Allowable costs			
(a) Purchases of goods, services and materials	2(a)		
(b) Wages, salaries and pensions	2(b)		
(c) Purchases of capital equipment, structures, and land	2(c)		
3 Total allowable costs *(sum of lines 2(a), 2(b), 2(c))*	3		
4 Taxable income *(line 1 less line 3)*	4		
5 Tax *(19% of line 4)*	5		
6 Carry-forward from 1984	6		
7 Interest on carry-forward *(10% of line 6)*	7		
8 Carry-forward into 1985 *(line 6 plus line 7)*	8		
9 Tax due *(line 5 less line 8, if positive)*	9		
10 Carry-forward to 1986 *(line 8 less line 5, if positive)*	12		

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continue their tax deductions. Banks or other interest-earners would have to pay a special 19 percent tax on those interest earnings attributable to people who are continuing to deduct the interest.

Second, certain categories of other deductions could be retained without compromising the basic principles of our proposal. For example, deduction of state and local property taxes could be continued. The deduction can be rationalized on the grounds that most property taxes support education, and deduction of investment in education is the counterpart of deduction of other forms of investment. Continuation of the deduction for at least some types of charitable contributions might also be justified on the same grounds.

Third, a compromise might involve a tax schedule that is not entirely flat. What really matters is that all tax rates, including the top one, be low enough to avoid distortion. A system with two brackets, say at 15 percent and 25 percent, would probably satisfy this criterion. It would work in the following way: All business income on Form 2 would be taxed at 25 percent. Wage earnings would be exempt up to the proposed level, then taxed at 15 percent to, say, $25,000, and then at 25 percent for the amount above $25,000.

Fourth, full write-off of investment is not absolutely essential, though we believe that the consumption principle associated with the write-off is highly desirable. A system with partial write-off might be acceptable, or even the continuation of accelerated depreciation and the investment credit.

The Treasury Proposal

In *Tax Reform for Fairness, Simplicity, and Economic Growth,* the U.S. Treasury set forth a detailed plan for comprehensive tax reform. Though it is apparent that many of the ideas in the Treasury proposal will never make it into law, it is worth noting how its good features could be combined with some of our ideas to get a workable improvement in the tax system.

The principal features of the Treasury plan are:

1. Modest reductions in marginal rates. The top personal rate would fall from 50 to 35 percent, and the corporate rate from 46 to 33 percent.
2. Elimination of all investment incentives. Write-offs would be limited to economic depreciation.
3. Full taxation of capital gains except for adjustment for inflation.
4. Inflation adjustment would reduce the fraction of interest income that is taxable and the fraction of interest spending that is deductible.

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5. Insurance and medical fringes included in personal taxable income.
6. Dividends half deductible to corporations.
7. Cap on individual interest deductions other than home mortgage and elimination of most charitable deductions and all state and local tax deductions.

Except for the interest deduction cap, all of these provisions fit into the general framework of making the tax system a pure income tax. The most severe criticism of the Treasury's proposal has come from those concerned with the adverse impact of an income tax on saving and investment. Because an income tax taxes both original earnings and the return on the portion of the earnings that is saved, an income tax provides a disincentive for saving and investment. Congress has modified the tax system to make it more of a consumption tax by providing the investment tax credit, accelerated depreciation, and 60 percent exclusion of capital gains. The Treasury wants to roll back this progress toward a consumption tax.

We foresee the possible development of a politically feasible and economically efficient tax reform by combining some of the features of the Treasury proposal with the basic idea of a consumption tax. Some of the changes in the proposal that might be part of this reform are:

1. First-year write-off for all investment, in place of economic depreciation. Elimination of the investment tax credit would remain part of the reform.
2. Lower top marginal rates for personal and corporate taxes to around 25 percent.
3. Comprehensive withholding of taxes on interest and dividends by business at the 25 percent rate. Full deductibility of dividends by corporations. The deductibility of interest and dividends by corporations against their 25 percent rate and the withholding for the personal tax at the same rate would offset each other.
4. Place a 25 percent tax on the sale of business assets. Eliminate the capital gains tax on individual gains in the stock market.
5. Instead of including fringe benefits as phantom income on individual tax returns, tax them at the 25 percent rate at the business level. This would mean that businesses would not be allowed to deduct the cost of those fringes.

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This revised version of the Treasury proposal takes care of all of the major defects of the existing proposal.[1] First and foremost, it would provide the strong investment incentives missing from the proposal as it stands. Second, by providing full deductibility of corporate dividends, it gives complete integration of corporate and personal taxes. Third, by providing airtight withholding on dividends and interest, it solves the problem of leakage on these items. Fourth, by eliminating personal capital gains taxation and taxing underlying corporate sales of assets instead, another major source of leakage would be eliminated. Fifth, by having businesses rather than individuals pay the tax on fringe benefits, the proposal gains in political acceptability at no sacrifice in economic efficiency. The revised Treasury proposal would be exactly the Hall-Rabushka proposal except for having one or two extra brackets in the tax schedule.

The Bradley-Gephardt Proposal

Like other tax reformers, Senator Bradley and Congressman Gephardt advocate lowering tax rates and broadening the tax base. Senator Bradley's book, *The Fair Tax*, sets forth the justification for and specifics of his reform measure.

Bradley and Gephardt call their plan a "comprehensive individual income tax proposal." The plan puts a basic tax at a rate of 14 percent on all income above an exemption level. Two surtax rates at higher levels of income add to the progressivity of the tax. The plan retains the most popular deductions in the current code: home-mortgage interest, charitable contributions, state and local income taxes and real property taxes, exclusion for social security and veterans' benefits, and exemption of interest on municipal bonds.

The most significant modification to present law is to treat the value of employer's contributions toward health and insurance premiums as cash income. Another key change from current law is the limitation placed on the remaining legal deductions. The two surtax rates would be imposed against total income, not taxable income, so the itemized deductions do not reduce the surtax. Everyone's itemized deductions count against the same 14 percent basic tax, and are therefore worth only 14 cents on the dollar. Today, the value of an itemized deduction reflects the taxpayer's top marginal rate. Under Bradley-Gephardt, the value of an itemized deduction would be a

[1]Treasury II (1985), which was released after this paper was written, does not effectively address the problems with Treasury I and is still far from our revised Treasury proposal.

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flat 14 percent. In effect, Bradley-Gephardt would remove most, but not all, of the value of deductions for higher income taxpayers.

To the extent that the real estate industry and charitable lobbies would be up in arms about eliminating the deductibility of interest and contributions under a flat tax, they would find little respite in Bradley-Gephardt. If the benefits of deducting mortgage interest are topped at 14 cents on the dollar, and if the subsidy for being charitable is no more than 14 cents on the dollar, both sets of current beneficiaries will find Bradley-Gephardt hard on their constituencies. Of course, the two members of Congress would argue, as would we, that people will increase their charitable giving as their real incomes rise (despite the smaller subsidy in the deduction) and that reduction of the top marginal rates will supply essential incentives for pursuit of a better performing economy.

Bradley and Gephardt have estimated that 80 percent of all taxpayers would pay at the simple 14 percent rate on their taxable income, the lowest rate in effect before the 1981 Reagan tax cuts.

The two surtax brackets would apply to the difference between total income and $40,000 (for joint returns) or $25,000 (for single persons). In other words, a family earning $90,000 would have to pay an additional 12 percent tax on all income between $40,000 and $65,000, and an additional 16 percent on income between $65,000 and $90,000. First, of course, the family would have to calculate the basic 14 percent tax liability on all taxable income, which excludes allowable deductions and personal exemptions.

As explained in *The Fair Tax*, Bradley-Gephardt would lower the corporate rate from the current maximum of 46 percent to a flat 30 percent. By eliminating the current exclusion for 60 percent of long-term capital gains, it would raise the business capital-gains tax from 28 to 30 percent. It would take away some of the accelerated depreciation in the 1981 tax cut by stretching out the current 3 to 15 year schedule, depending on the particular investment, to between 4 and 40 years. It would end the investment tax credit along with the exclusion of certain fringes.

Bradley justifies slower depreciation rates on the grounds that his proposed depreciation schedule accurately reflects the useful life of investments, in comparison with the 1981 accelerated schedules that treat investments too generously. In other words, he rejects the principle of the consumption tax, which provides an incentive in the form of a first-year write-off. Bradley calculates that his tax would collect from corporations the same revenue being collected under current law. Less depreciation would offset the lower flat-rate corporate tax of 30 percent.

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Bradley-Gephardt comes up short on the test of administrative efficiency. So long as business income from interest, dividends, rents, royalties, capital gains, professional activities, and farming is taxed at the individual level, as it will be in their plan, underreporting will persist, though it may diminish due to the lower top rate. The only successful way to tax such income is to tax it at its business source. So long as several tax brackets remain, people face incentives to shift income from high-bracket to low-bracket family members, and similar ploys.

Bradley admits that he and Gephardt have retained a handful of deductions because they are politically popular and, he claims, they promote fairness. Retaining these deductions will reduce the tax base by several hundred billion dollars. Unless they successfully contain the lawful deductions to the few they have chosen, lobbyists will ultimately get Congress to reinstate many of the other equally meritorious deductions they propose to repeal. Success on that front will put the tax system back where it started, with a shrinking tax base and the need to impose higher marginal rates.

Bradley and Gephardt are aware that the taxation of fringe benefits is one of the most badly needed reforms of the tax system. Unfortunately, they have chosen the wrong way to solve the problem. They would require that employers inform their workers about the value of the fringes each receives. The workers, in turn, would have to report the value as phantom income on their tax returns. They would have to pay tax on income they never receive. Even if they have no interest in a fringe benefit and value it at zero, they will have to pay tax according to a valuation assigned by the employer. There is no limit to the amount of phantom income a worker may have to pay tax on. Again, taxation at the source would be a far more workable principle (and politically more attractive, surely). Instead of making workers pay tax on phantom income, eliminate the deduction of fringes by the employer.

A much better version of Bradley-Gephardt could be created by fusing the administrative principles of our proposal with their tax rates and brackets. Extend the Bradley-Gephardt 30 percent corporate tax to all business, and eliminate all interest and fringe deductions under it. Make the personal tax apply only to wages, salaries, and pensions. The improved version would capture far more business income, eliminate the double taxation of dividends, and apply a much more practical technique to the taxation of fringes. It would be much fairer than Bradley-Gephardt, because a much larger fraction of the income going to the rich would be effectively taxed.

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Kemp-Kasten

Republican Congressman Jack Kemp and Senator Bob Kasten introduced the semiofficial Republican entry in the tax-reform derby rather late, with a starting date of April 1984. It bears the acronym FAST, meaning "fair and simple tax," but, again, we will refer to it by the names of its sponsors. In general, Kemp-Kasten would broaden the tax base by eliminating most tax preferences or loopholes and imposing on that broader base a uniform 24 percent rate. Corporations would pay a 30 percent standard rate, with a 15 percent break for small businesses earning up to $50,000 in taxable income.

Like Bradley-Gephardt, the two Republicans do not integrate the corporate and individual income taxes, but reform each separately. First the individual income tax: Kemp-Kasten would eliminate most deductions, credits, and exclusions, but would increase the personal exemption to $2,000 (for men, women, and children alike) and raise the standard deduction (zero bracket) to $2,700 for a single person or head of household and $3,500 for joint returns. Adding these numbers means that single taxpayers would start paying tax after $5,875 and a family of four is exempt from income taxes until it earns $14,375; the latter figure is substantially above the 1984 poverty line figure of $11,101 and the 1983 combined standard deduction and personal exemption of $7,400.

Kemp-Kasten will retain deductions for charitable contributions, mortgage and other interest paid, real property taxes, and medical expenses above 10 percent of adjusted gross income. Current treatment will be accorded to retirement annuities (IRAs, Keoghs, social security), military and veterans benefits, employer-provided benefits (fringes), foreign-source income, nonprofit tax-exempt bonds, employee business expenses, and moving expenses.

Although the measure would provide a standard rate of 24 percent, Kemp-Kasten builds a measure of graduation into the rate by granting a special exclusion of 20 percent of wage and salary income up to the social security wage base (about $40,000 in 1985), which would be gradually phased out as incomes approach $100,000. Thus, the effective rate up to $40,000 would be 20 percent, and the rate would rise in 1 percent increments until the standard 24 percent level bites at $100,000 and above. In the event income is less than $10,000, Kemp-Kasten will define any form of income as earned and thus eligible for the lower 20 percent effective marginal rate.

A key feature is the plan's emphasis on indexing for inflation, which encompasses personal exemptions, the zero-bracket amount, and the capital basis on which capital-gains taxes are computed. Thus infla-

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tion will not reduce the value of these exemptions (as would be the case in Bradley-Gephardt), nor would inflation impose taxes on nominal capital gains that did not represent real gains. During a 10-year transition period, the effective capital-gains tax rate would be 19 percent at the taxpayer's option, without indexing.

The features of the corporation income tax would be more generous than in Bradley-Gephardt. Although the tax rate of 30 percent is the same, Kemp-Kasten will retain the 1981 accelerated depreciation schedule, which permits write-offs of equipment in 3 to 5 years and of structures in 15 years. It will cut the capital-gains tax rate from 28 to 20 percent and provide for a foreign-income tax credit.

It should be noted that fringe benefits remain untaxed in Kemp-Kasten, still providing an incentive to channel compensation away from cash income to fringes. A top marginal rate of 24 percent, however, will make these less attractive than under current law.

The failure to integrate the corporate and individual income taxes means that Kemp-Kasten would continue the double taxation of dividend income—first at 30 percent on corporate profits, and then at 24 percent when received by individuals. The combined maximum rate will be 46.8 percent, a serious disincentive. Assuming smart businessmen take their income from capital gains instead of dividends, the combined total tax on entrepreneurship would be 43.3 percent, still a worrisome level.

Kemp-Kasten fails to deal with the two biggest sources of leakage in the tax system: fringe benefits and untaxed interest. Consequently, it will have to rely on high tax rates, especially on entrepreneurship, to generate its revenue. As with the Treasury proposal and Bradley-Gephardt, a much improved version could be made by taking the key administrative ideas from our plan and combining them with the Kemp-Kasten tax schedule. Taxation of interest and fringes at the source would be the key to improving this proposal.

Conclusion

The current push for tax reform is only part of a broad, long movement to unwind the mistakes built into the tax system during the Depression and World War II. Major tax rate reductions occurred in 1964, 1969, and 1981. Improvements in investment incentives were made in 1954, 1962, and 1981. If the 1985–86 round can get the top marginal rate down to 25 or 30 percent and consolidate investment incentives with first-year write-off, it will be another important milestone in the long process of improvement.

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Questions of whether the tax schedule is exactly flat, or precisely what deductions are to be allowed to individuals, are quite subsidiary to the central issues of lower rates and proper investment incentives. We favor a system where deductions are completely eliminated and taxation occurs at the source of income, because this system maximizes the tax base and permits the truly low rate of 19 percent. But other systems, which continue some deductions and have somewhat higher rates, could come close to the benefits of the ideal system we have proposed.

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REVENUE AND DISTRIBUTIONAL IMPACTS OF THE HALL-RABUSHKA FLAT TAX PROPOSAL

Eric W. Cook

It seems appropriate that, because I work for the Joint Committee on Taxation, I emphasize a political perspective in my analysis of the paper by Professors Hall and Rabushka (1985), advocating a flat tax. Most of the other major tax reform proposals generally attempt to be revenue and distributionally neutral. This means that they are designed to neither increase nor decrease taxes, in both the aggregate and by specific income classes. These are the issues of primary concern to policymakers. Therefore, I intend to concentrate on the revenue impact of the Hall-Rabushka tax plan as well as its effect on the distribution of tax liabilities across income classes.

Background on the Joint Committee on Taxation

Before proceeding with my discussion of the Hall-Rabushka tax plan, I would first like to provide a little background about the Joint Committee on Taxation. In addition to the five members from the Senate Finance Committee and the five members from the House Ways and Means Committee, the Joint Committee on Taxation consists of a professional staff whose responsibilities include the analysis of virtually all tax legislation that goes before the U.S. Congress. The Joint Committee on Taxation is strictly nonpartisan.

It is the Joint Committee on Taxation that has analyzed the Bradley-Gephardt, Kemp-Kasten, and Roth-Moore tax reform proposals, as well as several others. These analyses, in which incidentally I have participated, have relied substantially on the Treasury Department's Individual Income Tax Model. This model, which is used exclusively

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by the Joint Committee and the Treasury Department, uses actual tax returns that are weighted to simulate the taxpaying population. Proposals are analyzed by comparing the tax liability that would result under a present-law base to that of a given alternative. The Individual Income Tax Model has proven to be a reliable and useful tool for providing policymakers with assessments of the revenue effects of changes in the tax code both in the aggregate and by income class.

The Revenue Impact of the Hall-Rabushka Plan

Professors Hall and Rabushka contend that their flat rate tax would result in revenue neutrality in a manner similar to that of the Treasury's November 1984 proposal (Treasury I). The plans are similar in that both propose a tax cut for individuals to be equally offset by tax increases for businesses. They differ in that the Hall-Rabushka plan would go much further in shifting the relative tax burden from individuals to businesses.

My analysis of the Hall-Rabushka plan, which used the Individual Income Tax Model as the basis for most of the estimates, confirms the accuracy of Hall and Rabushka's estimate of what the revenue impact would have been for individual income taxes in 1983. They estimate that in 1983 the Hall-Rabushka plan would have raised about $80 billion less than the actual amount of approximately $285 billion. Also, I would add that, using the macroeconomic assumptions of the Congressional Budget Office (CBO), the Hall-Rabushka tax plan would lose about $100 billion from projected present-law tax liabilities of individuals in 1986. By 1990, the Hall-Rabushka plan would have a tax liability shortfall for individuals of about $115 billion without indexation of the personal allowances and the dependent's exemption amount. If indexation were retained, the plan would lose about $180 billion by 1990 from individual income taxes.

These substantial tax cuts are to be offset by tax increases for businesses, which would represent an approximate doubling of business taxes. These tax increases are to result from the repeal of the deductibility of employer contributions for social security taxes and fringe benefits. These deductions amounted to about $300 billion in 1983. In addition, the interest paid deduction for businesses would be repealed, which amounted to over $550 billion in 1982.

The tax increases resulting from these repealed deductions would be diminished, however, by expensing. Briefly defined, expensing is the full deductibility of investment in a depreciable asset in the year of the investment. Excluding investment in used property, in

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1982 investment in structures, plant, and equipment amounted to about $550 billion, whereas business depreciation in 1982 amounted to over $225 billion. These figures suggest that depreciation deductions would be significantly increased under the Hall-Rabushka tax plan.

The purpose for citing these statistics is that these repealed deductions and expensing represent dramatic changes in firms' deductions. Consequently, there would be large shifts in firms' tax liabilities. It is possible that the firms experiencing large tax increases would choose to conduct business in other countries that afford more favorable tax treatment. It is also possible that these same firms simply would discontinue operating entirely. As a consequence, it is uncertain whether these changes would actually translate into the tax increases estimated by Professors Hall and Rabushka.

Assessment of the impact on business taxes of the Hall-Rabushka tax plan is very complex and difficult to predict, especially using aggregate data. Therefore, I am uncertain about its impact in this area, and I am skeptical about the estimate of the amount of tax increases for businesses that would be necessary to offset the income tax cuts for individuals.

The Distributional Impact of the Hall-Rabushka Plan

The distribution of individual income taxes by income classes under the Hall-Rabushka plan would be one where most income classes would receive a tax cut, but the tax reductions would significantly favor the wealthy. In fact, using 1983 income levels and 1986 tax law, the overall distributional effect would be a 3 percent tax cut for the below $20,000 income class, a 6 percent tax cut for the $20,000 to $50,000 income class, a 30 percent tax cut for the $50,000 to $100,000 income class, and finally, a 70 percent tax cut for the above $100,000 income class.

This result follows because the present system, contrary to what many believe, is significantly progressive with the top 25 percent of the income distribution paying about 70 percent of individual income taxes in 1983, the top 7 percent paying about 40 percent, and the top 1 percent paying about 20 percent. Because the average tax rate for the above $200,000 income class exceeds 25 percent, a 19 percent tax rate generally will result in a significant shifting of the relative tax burden from the wealthy to the lower- and middle-income classes.

Conclusion

The distributional problem of shifting the relative burden of taxes to the middle- and lower-income classes under the Hall-Rabushka

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plan possibly could be remedied by full inclusion of capital gains, interest, and dividend income combined with an alternative rate schedule with a top rate of 30 percent or higher. If corporate integration were still a primary goal, a dividend deduction for corporations is an alternative approach that generally is regarded to be a more equitable approach than other alternatives. Although corporate integration may be a desirable goal and a single tax rate might be simpler, it is the issue of vertical equity that is generally of more importance to policymakers. Therefore, a tax reform plan that attempts to achieve simplicity and corporate integration should also carefully consider the distributional impact in order for it to be politically viable.

The expensing portion of the Hall-Rabushka plan, which is the component that makes the plan a consumption tax, very easily could turn into a significant tax sheltering device. As a result, instead of reducing tax avoidance behavior, tax shelters might actually be encouraged because of the large depreciation deductions that this would permit in excess of the actual amount of money invested. An alternative approach to taxing consumption is one that is employed in the Roth-Moore bill with its super-savers accounts, which are similar to expanded IRA accounts with no penalties for withdrawals.

If these changes were made to the Hall-Rabushka tax plan, not only would the plan be made more equitable, but the revenue impact would also be much more predictable and, as a result, more likely to be able to raise a comparable amount of revenue as present law.

Most of the criticisms that I have made of the Hall-Rabushka plan involve normative judgments and are thus political in nature. I believe that the Hall-Rabushka proposal represents a significant contribution to the overall tax reform debate. In fact, their work of the last several years has played a major role in shaping the current tax reform movement.

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A FAIR, SIMPLE, AND PRO-GROWTH TAX REFORM

Jack Kemp

Politics and Economic Theory

In any serious discussion of tax reform the relative roles of the politician and the economist need to be examined. I know that some theories of public choice take a rather dim view of politicians, and perhaps not without reason—just as many people today take a rather dim view of economists. But we cannot dispense with politicians, any more than we can dispense with economists. What we need are politicians and economists who are better at understanding and dealing with reality. I would like to suggest that this requires us carefully to observe the limits of pure theory. Economic or political theory is a more or less useful abstraction from the lives of real people. But each abstraction takes us further away from that concrete reality. For example, general equilibrium theory, useful as it is, has no role for the entrepreneur; in the same way, some public choice models have no role for the entrepreneurial politician. It is the economist's job to determine what is desirable and achievable from the point of view of economic policy; it is the politician's job to determine, with the help of experts from other fields, what is desirable and achievable from the point of view of social policy; and we need everyone working together to come up with the best tax reform plan. No single perspective is enough.

I offer this caveat for the following reason. Last year in testimony to the Senate Finance Committee, I commented at some length upon what I consider a remarkable fact about federal tax reform. In the world of tax economists, there are two competing consistent theories of tax reform—the comprehensive income tax, and the consumption tax. Each of these theories has been worked out in considerable detail

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for decades by leading tax economists. Each has its own partisans. Yet of the three tax reform proposals that are generally agreed to have the best chance of enactment by the Congress, none is a consistent embodiment of either theory. In key areas like depreciation and capital gains, Bradley-Gephardt and the Treasury plan shade toward the comprehensive income tax; but in others, such as the treatment of retirement pensions, they follow the treatment of the consumption tax. Kemp-Kasten has more of the incentives for saving and investment which characterize the consumption tax than either of the other plans; yet one of its distinguishing features is an exclusion for *labor* income, and Kemp-Kasten is the most favorable in its treatment of fringe benefits. In short, each of the three plans is a hybrid of the two "pure" approaches, though each has its own unique mixture.

We could explain this by saying that politicians never do what they are supposed to. Or, this apparent inconsistency could reflect consistency to a higher principle. It is apparently inconsistent for a sailboat to tack back and forth instead of sailing directly from Point A to Point B; but it turns out to be the quickest way. Of course, if you are driving a motorboat, it is another story. But that is really my point: we have to recognize the limits of any theory that tells you how to plot a course but abstracts from whether you are in a sailboat or in a motorboat. When it comes to the ship of state, it is the job of politicians to observe those kinds of distinctions, and this may help explain the different perspectives of the politician and the economic theorist concerning tax reform.

I am not saying you have to compromise your principles in order to achieve something politically. On the contrary, the only way you can accomplish anything in the long run is if your principles are fixed. If we want a whole loaf, we may only be able to get half a loaf; but we will not get a single slice if we cannot decide whether we want bread or buttons. Too often we fail because we change our principles rather than trying to change reality; because it is easier. As somebody once remarked, if more of our politicians were idealists, we might get something practical accomplished.

Now, the politicians who have been most entrepreneurial in moving the issue of tax reform have all gravitated toward a similar set of political ground rules. First, the new tax code must be "revenue neutral" in a static sense, neither raising nor losing revenue, apart from the dynamic effects resulting from new incentives. Second, the new tax code must not significantly shift the distribution of the federal tax burden on individuals by income class, compared with current law. Third, the new tax code should significantly lower marginal tax rates compared with current law, and so far as possible, minimize

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the distortions of economic decisions which are due to the tax code. Finally, tax reform should encourage economic growth, not hinder it. You can argue with any one of these limitations on policy, but I believe these are roughly given.

Both the pure flat income tax and the pure flat consumption tax violate some of these objectives. Briefly, a pure flat rate, comprehensive income tax tends to shift the tax burden from the top to the bottom of the income scale; or else, with a sizable income tax threshold, the tax burden will be shifted toward the lowest income families who continue to pay taxes, if revenue neutrality is to be maintained. A pure comprehensive income tax also tends to maintain or increase the disparity of treatment of certain economic activities, such as consumption and saving.

A pure consumption tax has a worse problem distributionally, because so much saving, which would be tax deferred under a consumption tax, is done by upper income taxpayers. To maintain distributional neutrality, a pure consumption tax would have to maintain fairly high marginal tax rates. The transition to such a system can also be quite long and complex. And a consumption tax as usually understood tends to discriminate against certain taxpayers, such as families with children, whose station in life requires them to "consume" more than other taxpayers of an equal income—though I will argue that raising children should be viewed in many ways as an investment.

I would not like to leave you with the impression that the major tax reform plans are without any consistent principles. My purpose, in fact, is precisely to put forward the philosophy behind Kemp-Kasten in some detail. Within the broad political agreement that exists on principles of tax reform, however, there can be surprising differences in philosophy. Hence, in addition to stating the general case for tax reform, there is a need to state the specific case for Kemp-Kasten.

Kemp-Kasten: General Outlines

Most of you are probably aware of the broad outlines of the Kemp-Kasten "Fair and Simple Tax" (FAST). But perhaps it is less clear how the specific provisions are interrelated. And you may not be aware of some significant improvements to our bill, especially concerning the treatment of capital gains and depreciation, which were added when our plan was reintroduced in the new Congress on 30 January 1985 (H.R. 777, S. 325). Let me first describe the proposed

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reform of the individual income tax, then capital gains, and finally the business side.

As I said, I cannot give you a single rigorous tax theory about Kemp-Kasten. But I can give you a consistent social philosophy for it. I consider the "Fair and Simple Tax" first and foremost a "pro-family" tax reform. In many important respects we have been guided by considering the impact of the tax code on the traditional one-earner family of modest means with children. We try to do our best by everyone, and we have special provisions favorable to senior citizens, the working poor, single people, and two-earner couples. After all, a family does not stop being a family when the children grow up and the parents grow old. But on the whole the traditional family is our norm—a norm, I might add, that is not culled from polling data or from statistics about the way Americans live, but rather from an idea of how we think they would prefer to live if they had the chance. There is, if you will, a natural-law basis for our bill, though one which sees the family rather than the individual considered in the abstract as the basic unit of society.

Treatment of Individuals

The details of Kemp-Kasten's treatment of individuals are fairly easily described. Concerning the tax base, we retain the current deductions for mortgage interest, real property taxes, charitable contributions, and catastrophic medical expenses, as well as the tax deferral of all kinds of retirement saving. We also retain the exclusion for employer-provided health and life insurance. Many of the other tax preferences in the tax code are eliminated. The personal exemption is doubled to $2,000, and the exemptions and zero bracket amounts are indexed for inflation.

Wage Exclusion

A prime distinguishing feature of Kemp-Kasten is that instead of three marginal tax rates—as in Bradley-Gephardt or the Treasury I proposal—we have a 24 percent flat tax rate on taxable income, combined with a "progressive" or "disappearing" exclusion. In general, taxpayers may exclude one-fifth of wages and salaries up to the amount they pay on social security tax. The social security wage base is expected to be $41,700 in 1986, which would make the maximum wage exclusion $8,340 in that year. The wage base is indexed by law to grow with inflation and real average wages.

There are two special rules. First, taxpayers with wages and salaries less than $10,000 for single people, or $15,000 for married cou-

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ples, may exclude 20 percent of income from any source up to those amounts. Second, two-earner couples with combined wages in excess of the social security wage base may exclude 20 percent of the total amount on which they paid the payroll tax.

The exclusion figured in this way is phased out at upper incomes by adding back an amount equal to 20 percent of a taxpayer's income in excess of the social security maximum taxable earnings base. This means the exclusion falls to zero at twice the FICA wage base, or $83,400 in 1986.

When you phase out a benefit according to an income test, the phasing out causes an increase in effective marginal tax rates—in this case from 24 percent to 28.8 percent (1.2 × 0.24). Our earlier versions of the bill had a "notch" when the effective marginal tax rate fell from 28 percent to the flat 25 percent rate once the wage exclusion was completely phased out. Also, the exclusion provided for non-wage income was not phased out. In the new bill, we have modified the phaseout so that it applies to both labor and capital income, and the marginal tax rate effectively stays at about 28 percent for all taxpayers above the social security wage base. After the exclusion falls to zero, the continued phaseout behaves like a small surtax that keeps the effective marginal tax rate at 28.8 percent for all upper income taxpayers.

We believe the flat rate plus wage exclusion has several major advantages over progressive income tax rates. It allows a much higher tax-free income threshold than the other tax reform plans without greater cost. It also allows a lower marginal tax rate at the top. It substantially equalizes the tax rates on labor and capital income, resulting in a virtually flat combined income and payroll tax rate at all incomes above the income tax threshold. Finally, it avoids the tax burden shifting associated with a pure flat income tax rate.

In order to explain these advantages, let me return to our philosophy, and examine the combined effect of all the Kemp-Kasten provisions on American families and households.

The Wage-Earner

For many years there existed a distinction between employment and investment income for upper-bracket taxpayers, which most tax experts agreed should be removed. This distinction was removed in the 1981 tax act, when the top rate on investment income was cut to the 50 percent maximum tax rate on labor income. However, there still exists a distinction between labor and capital income at middle and lower incomes, due to the fact that workers pay a marginal tax rate that is higher by the amount of the payroll tax. Under current

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law the payroll tax is added on top of the personal income tax rate for labor income, but not capital income. Since the payroll tax base stops at about $40,000, the marginal tax rate on labor income can be higher at a lower income level than at a higher income level. For this reason, a purely flat income tax rate without a partial wage exclusion would not really be flat: a 24 percent flat rate would really be a 31 percent combined tax rate below $40,000, and 24 percent above $40,000. The two problems exist under current law and all tax reform plans except Kemp-Kasten.

For example, in 1986 a nonitemizing single taxpayer earning $35,000 would pay marginal tax rates of 34 percent under current law, 26 percent under Bradley-Gephardt, and 25 percent under Treasury I on *capital* income—but 41 percent under current law, 33 percent under Bradley-Gephardt, and 32 percent under Treasury I on *labor* income. Because of the wage exclusion and flat rate, under Kemp-Kasten the same taxpayer would pay 24 percent on capital income and 26 percent on labor income.

Viewed by income level, the combined marginal tax rate structure above the income tax threshold behaves as follows under the various plans. Current law: the tax rate starts at 18 percent, rises to 41 percent, falls to 34 percent, then rises to 50 percent. Bradley-Gephardt: the tax rate starts at 21 percent, rises to 37 percent, then falls to 30 percent. Treasury I: the tax rate starts at 22 percent, rises to 42 percent, then falls to 35 percent. Kemp-Kasten: the tax rate starts at 26 percent for labor income, 24 percent for capital income, and ends at 28 percent for both.

Though Kemp-Kasten raises about the same amount of individual income tax revenue as Bradley-Gephardt, and more than Treasury I, the Kemp-Kasten wage exclusion permits both a higher income tax threshold and a lower top marginal tax rate than under either alternative. For a family of four, the sum of personal exemptions and the zero bracket amount is about the same under all three plans: $11,800 under the Treasury plan, $11,500 under Bradley-Gephardt, and $11,300 under Kemp-Kasten. But the wage exclusion raises the income tax threshold under Kemp-Kasten 25 percent higher, to $14,125, or almost twice the $7,700 threshold under current (1985) law. For a single taxpayer, the income tax threshold is $5,750 under Kemp-Kasten, compared with $4,800 under the Treasury plan, $4,600 under Bradley-Gephardt, and $3,430 under current law.

Besides having the highest tax-free level of income at the bottom, Kemp-Kasten has the lowest marginal tax rate at the top. Kemp-Kasten raises about the same amount of revenue in static terms from

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taxpayers over $100,000 as the Treasury plan, despite a much lower top marginal tax rate—28 percent instead of 35 percent.

This is due in large part to the flat rate and disappearing wage exclusion. The exclusion effectively lowers the marginal tax rate from 24 percent to 19 percent below about $40,000, while phasing out the exclusion effectively raises the marginal tax rate from 24 percent to about 28 percent above $40,000. However, Kemp-Kasten raises more revenue and results in greater progressivity of the tax burden than an ordinary system of progressive rates of 19 percent and 28 percent, for two reasons.

First, the exclusion applies to wages and salaries, but not generally to interest and dividends. As I mentioned, this offsets the payroll tax and equalizes the tax rates on labor and capital income. This raises more revenue from a number of sources of nonwage income than an ordinary system of progressive tax rates.

Second, deductions and exemptions are deducted against the 24 percent flat rate, even when the effective marginal tax rate is 19 percent or 28 percent. This increases the value of deductions below about $40,000, and reduces them slightly above $40,000, compared with the effective marginal tax rate. The result is greater progressivity in the tax burden than would result from an ordinary system of progressive income tax rates.

Families with Children

One reason I call Kemp-Kasten a "pro-family" tax bill is its treatment of the personal exemption. In general, we believe that people, and especially children, should not be treated as so many consumer durables, like refrigerators and sailboats, but rather as investments in human capital.

The tax code has traditionally offered some relief for families with children through the personal exemption. Yet if the personal exemption, which was $600 back in 1948, had been indexed since that time for inflation, it would be more than $2,500 today. If it had been indexed as a share of total income, the exemption would be more than $5,500 today. By almost any measure the decline in the personal exemption has been the largest single change in the income tax in the postwar era. Because of this and other changes in tax law, the rise in the tax burden since the Second World War has been about twice as fast for families with children as for single taxpayers and childless couples.

Bradley-Gephardt increases the exemption for adults to $1,600, but reduces the exemption for dependent children from $1,040 in 1985 to $1,000 in 1986, and also repeals inflation indexing of these

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amounts. However, because of the higher bottom tax rate, the value of the exemption for each child rises from $114 to $140 a year. Since the Bradley-Gephardt plan allows the exemption only against the 14 percent bottom tax rate, the exemption is worth $140 for all taxpayers, including those in the 26 percent and 30 percent tax brackets. This represents a reduction of the tax value for the exemption in the top bracket from $500 to $140.

Kemp-Kasten doubles the personal exemption for everyone to $2,000 and retains indexing. Treasury I also increases the personal exemption to $2,000, plus indexing; but because of the different rate structures, the effect of the $2,000 exemption is different under Treasury I than under Kemp-Kasten.

With progressive tax rates, as under Treasury I, the value of a deduction rises with your income. Under the Treasury plan, the value of each child exemption rises from $114 to $300 at the bottom, but it rises from $500 to $700 in the top tax bracket. Under Kemp-Kasten, all deductions, exclusions, exemptions, etc., are worth 24 cents on a dollar. The difference is especially important with the personal exemption for dependent children. Under Kemp-Kasten, the value of each exemption at a low income more than quadruples, from $114 to $480 a year, while in the top bracket the value of the exemption remains about the same, $480 compared with $500 under current law. The increased tax value is concentrated at middle and low incomes. Because the personal exemption is such a large revenue item, this is another reason why the top marginal tax rate can be lower under Kemp-Kasten than under the Treasury plan.

Both Bradley-Gephardt and the Treasury plan repeal the child care credit and replace it with a deduction for child care expenses. Kemp-Kasten repeals the credit without replacing it with a deduction. While this is relatively more favorable to traditional one-earner families with children, under realistic assumptions (that is, assuming child care expenses bear some reasonable relationship to the additional income earned by the second wage earner in a family), in general the Kemp-Kasten treatment is absolutely more favorable for low- and moderate-income two-earner families than either Bradley-Gephardt or the Treasury plan. For example, a nonitemizing family of four earning $15,000, with the second spouse earning a third of the income and child care expenses equal to a tenth of the family's total income, pays a federal income tax in 1986 of $393 under current law, $475 under Bradley-Gephardt, $419 under Treasury I, and $168 under Kemp-Kasten. With only one earner and no child care expenses, the federal tax is $868 under current law, $532 under Bradley-Gephardt, $480 under Treasury I, and $168 under Kemp-Kasten.

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In this way, Kemp-Kasten provides the same tax treatment to all families with children, regardless of the parents' employment status. Any other approach seems to imply that the effort of the parent who stays at home to care for the children is worth less than if he or she worked outside the home. It does not seem fair to recognize the expense of earning a second income, but ignore the cost of giving up a second career, which often goes with the decision of a spouse to remain at home to raise the children.

Two-Earner Couples

Kemp-Kasten does remove a bias against two-earner couples that exists under current law and the other major reform plans. All three plans repeal the "marriage penalty" deduction, which is a current-law exclusion of 10 percent of the wages of the lesser-earning spouse, up to a maximum $3,000 deduction. When this feature was enacted in 1981, one justification was that a second income can often put a couple into a higher tax bracket, putting two-earner couples at a disadvantage relative to single taxpayers earning the same combined income. The deduction was an attempt to offset this "marriage penalty." However, it created a new problem of equity. Now, two families with exactly the same income and itemized deductions can pay a different federal tax—the tax for a two-earner family being lower than for a one-earner family. In all three major tax reform plans, repeal of the second-earner deduction is justified by the flattening out of marginal tax rates—and Kemp-Kasten has the flattest combined marginal tax rates.

However, a two-earner family with combined wages in excess of the social security payroll tax base pays a higher social security payroll tax and therefore a higher combined marginal tax rate than other taxpayers on the same income. This is because a family with one wage-earner pays the payroll tax on up to about $40,000; but a family with two wage-earners can pay tax on up to twice that amount. Under Kemp-Kasten, two-earner couples may figure out their 20 percent wage exclusions separately and add the two, if this results in a larger total exclusion. This offsets 5 of the 7 percentage-point increase in the combined marginal tax rate that occurs under current law and the other tax reform plans. In a sense, then, the Kemp-Kasten wage exclusion acts like a second-earner deduction for married couples.

The Working Poor

Families currently living in poverty pay rather stiff rates of federal income tax. The poverty level in 1985 is $11,101 for a family of four, while the income tax threshold for a family of four is $9,440 (including

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the earned income tax credit), or almost 20 percent lower. Much of the worst impact of inflationary bracket creep has been felt by low income families, who used to be exempt from income tax but have been swept on to the tax rolls by inflation. The tax disincentives are compounded because in many cases the disposable income obtainable through transfer payments for not working is almost as great as or even greater than after-tax wages at a comparable income. This is the famous "poverty trap."

Kemp-Kasten addresses this problem in several ways. One way is significantly to raise the tax-free threshold of income. The income tax threshold for a family of four is increased from $9,440 to $14,125. The income tax threshold for a single head of household with two dependents is increased from $8,375 to $10,750. This removes about 1.5 million of the lowest income taxpayers from the tax rolls, and indexing will keep them off the rolls permanently as long as they are poor.

Another Kemp-Kasten change is to modify the earned income credit in order to reduce high effective marginal tax rates at low incomes. Under current law, the earned income credit is 11 percent of earned income up to $5,000. The maximum credit of $550 is constant between $5,000 and $6,500, and is then reduced by 12.22 percent of income in excess of $6,500. The credit disappears at $11,000. Since the phaseout of the credit adds a marginal tax rate of 12.22 percent to the statutory tax rate, and the bottom income tax brackets overlap the phaseout range of the earned income tax credit, this can result in fairly high effective marginal tax rates under current law and under the other tax reform plans. For example, a single head of household earning $10,000 with one dependent faces a marginal income tax rate of 26 percent under current law and under Bradley-Gephardt, and 24 percent under Treasury I, plus the 7 percent payroll tax rate and the 50–75 percent effective marginal tax rates from forgoing transfer payments.

Kemp-Kasten reduces these effective marginal income tax rates by coordinating the earned income credit and the normal income tax thresholds. We increase the credit from 11 percent to 15 percent, thereby increasing the maximum credit from $550 at $5,000 to $600 at $4,000. But we phase out the credit completely at $8,000—just below the $8,250 tax threshold for a single head of household—in order to end the overlapping which causes the spike in effective marginal tax rates. This reduces effective federal marginal income tax rates on the working poor by about 25 percent below current law and the other tax reform plans. Kemp-Kasten also indexes the earned income credit for inflation, for the first time.

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Important as the "poverty trap" is, cutting high effective marginal tax rates alone will not magically cure poverty. The more we understand about the causes of poverty, the more we are drawn to the conclusion that it has at least as much to do with the stability of families as with after-tax income. While this question goes far beyond the realm of tax policy, I believe that the "pro-family" aspects of Kemp-Kasten should be considered as an integral part of its anti-poverty strategy.

Homeownership

The Kemp-Kasten philosophy is unabashed in believing that homeownership ought to be encouraged. Families should be encouraged to become property owners in general, because it increases their economic independence and self-reliance; but homeownership is especially important. I believe that more than nostalgia has made the house with the white picket fence a traditional part of the American dream. Every family needs a piece of property that represents its special zone of freedom and even self-expression.

One of the interesting features of Kemp-Kasten is that in addition to cutting the tax burden, it increases the value of homeownership for typical families earning less than the median income. Our bill retains the deductions for mortgage interest and real property taxes. And as with the personal exemption, the value of these deductions is increased at moderate and lower incomes, though reduced at high incomes. The effective marginal tax rate on wages is 19 percent, because of the exclusion, but deductions are worth the full 24 percent flat tax rate. According to the National Association of Homebuilders (NAHB), Kemp-Kasten would reduce the cost of homeownership by 3 percent for a typical family earning $20,000 a year, while the Treasury and Bradley-Gephardt plans would increase the cost by 6 percent and 10 percent respectively.

Incidentally, the treatment of homeownership under current law and Kemp-Kasten is essentially similar to its treatment under a consumption tax: families must pay principal out of after-tax income, but the imputed rent is not taxed. I do not believe that tax theory requires us to punish homeownership.

Investment in Human Capital

While Kemp-Kasten contains more of the savings and investment incentives of a consumption tax than either Bradley-Gephardt or the Treasury plan, it differs significantly in its approach to investment in human capital. Kemp-Kasten disallows the deductibility of interest for consumer credit, which is more stringent than either Bradley-Gephardt, which allows all interest up to the amount of investment

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income, or the Treasury plan, which allows all interest up to the amount of investment income plus $5,000. Kemp-Kasten makes an exception, however, for interest on education loans, on the theory that this reflects investment in human capital.

Progressivity plays a role here as well. Progressive tax rates plus tax deferral of retirement savings, as with individual retirement accounts (IRAs), are favorable to capital income because a taxpayer is generally in a lower tax bracket after he retires than when the deduction is made. Progressivity has the opposite effect, though, for the few deductions allowed for investment in human capital, because a person is generally in a low tax bracket when the investment is made, but the increased value of personal services push the taxpayer into a higher tax bracket. The Kemp-Kasten treatment of deductions is therefore more favorable to investment in human capital than either current law, a progressive consumption tax, or the other tax reform plans.

Although Kemp-Kasten repeals the state and local income and sales tax deduction, we retain the deduction for property tax for reasons beyond encouraging homeownership. In particular, the property tax is almost always devoted to local education, and retaining the deduction is a way of offsetting the bias against investment in human capital.

Like current law and the other two plans, Kemp-Kasten continues the deduction for catastrophic medical expenses—unreimbursed costs which exceed 10 percent of adjusted gross income. However, Kemp-Kasten also preserves the exclusions for employer-paid health and life insurance. If it is permissible to compare human beings with physical capital, these costs could be viewed as depreciation allowances for human capital. We believe that private rather than public insurance of risk should be encouraged where possible. When the private sector is discouraged from providing for such basic needs, the usual result is to increase the pressure for public provision.

Bradley-Gephardt taxes both employer-paid health and life insurance; the Treasury plan taxes group term life insurance premiums and caps the exclusions for health insurance. Proponents of these approaches have pointed to extravagant use of fringe benefits by highly paid executives. However, Kemp-Kasten effectively curtails the inordinate attractiveness of fringe benefits at upper incomes by cutting the value of deductions in half in the top tax bracket, through marginal tax rate reduction. Once again, however, the Kemp-Kasten treatment actually increases the value of the medical and life insurance exclusions at low and moderate incomes.

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Senior Citizens

Kemp-Kasten has two primary features that help senior citizens. First, Kemp-Kasten increases the personal exemptions for each senior citizen from $2,080 to $4,000 (which amount is indexed for inflation). (Bradley-Gephardt increases the total exemptions to $2,600, while the Treasury leaves the exemption at $2,000, plus a special credit at low incomes.) Second, the special rule allowing the 20 percent exclusion to apply to all income up to $10,000 (single) or $15,000 (joint) is designed to protect senior citizens who live mostly from investment income rather than from wages (which benefit from the wage exclusion). These amounts are indexed for inflation. Together, these two provisions substantially increase the income tax threshold for senior citizens—from $7,700 to $14,125 for a retired couple, and from $4,470 to $8,250 for a retired single person.

In addition, reducing the top income tax rate from 50 percent to 28 percent, and continuing the exclusion for income from general-obligation municipal bonds, is beneficial to people whose income is primarily from investment of lifetime savings.

The deductibility of property taxes is also especially important for senior citizens. For retired homeowners who have paid off the mortgage, it is often the largest itemized deduction. And because the property tax is a tax on capital rather than on income or consumption, its incidence is greatly magnified. Assuming a 4 percent real rate of return, a 2 percent property tax is equivalent to a 50 percent marginal income tax rate. Under current law, federal deductibility can mean the difference between a 25 percent and a 50 percent income-tax-rate-equivalent.

The "96 Percent Bracket"

Beyond these general advantages, Kemp-Kasten addresses a number of anomalies in current tax law that affect senior citizens, largely due to the lack of coordination between the income tax code and other government programs. A combination of tax and benefit provisions can result in what has been called the "96 percent bracket" for senior citizens, though it can actually exceed 100 percent. These high tax rates are caused by an interaction of the following provisions.

First, the "retirement test" reduces social security benefits by 50 cents for every dollar above $7,320 earned by those between the ages of 65 and 70. This creates, in effect, a 50 percent marginal tax rate on wages and salaries for social security beneficiaries.

Second, the 1983 social security amendments effectively increased the federal marginal income tax rate on many senior citizens to at least 150 percent of the statutory rate. This is because a taxpayer

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must add 50 cents in benefits to taxable income for each dollar of income above a certain threshold of redefined adjusted gross income—$25,000 for single taxpayers and $32,000 for married couples—until one-half of benefits are taxed. For a taxpayer in the 30 percent tax bracket this effectively raises the rate to 45 percent. Finally, such taxpayers must also pay ordinary federal, state, and local income and payroll taxes.

In addressing these problems, we face a number of complicated issues. How should social security be treated? Under the current system benefits are partly based on contributions and partly redistributive. The system is funded by deductible employer contributions, nondeductible employee contributions, and even general revenues, thanks to a temporary income tax credit and the fact that income tax levied on social security benefits is returned to the social security trust fund. Within the system, redistribution occurs not only between income classes but across generations. Any treatment must take into account someone already retired, someone who retires this year, and someone who will retire in 50 years.

Most of these issues simply cannot be addressed within the context of income tax reform. In general, in Kemp-Kasten we have tried to reduce excessively high marginal income tax rates on senior citizens without changing the basic structure of social security.

Kemp-Kasten eliminates the "96 percent bracket" in two ways. First, the bill phases out the retirement test, by cutting the benefit reduction from 50 to 25 cents on a dollar of earnings immediately, and zero benefit reduction after five years. Second, the bill reduces the marginal taxable amount of social security benefits, from 50 to 25 cents per dollar of income in excess of the adjusted income thresholds, although up to half of benefits may still be taxed.

The result is a substantially reduced effective marginal tax rate. For example, a retired couple with $32,000 in adjusted gross income and $12,000 in social security benefits would have been in the 25 percent federal income tax bracket in 1984 before the new method of taxing social security benefits was enacted. The new method of taxing benefits effectively pushes the family from the 25 percent bracket into the 42 percent bracket on investment income, while the retirement test adds another 50 percent marginal tax rate on wages and salaries. Together with the payroll tax, this results in a 99 percent effective marginal tax rate on wages.

Kemp-Kasten's provisions reduce the effective marginal tax rate due to the retirement test from 50 percent to 25 percent, then to 0 percent. The effective marginal federal income tax rate is cut from 42 percent to 24 percent, both because of marginal tax rate reduction

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and because of the new method of taxing social security benefits. The combined effective marginal federal tax rate on this family's wages is ultimately cut from 99 percent under current law to 31 percent under Kemp-Kasten.

Investment Incentives

Capital Gains

An especially important feature for the encouragement of initiative and risk-taking is the treatment of capital gains. The Treasury plan taxes capital gains as ordinary income but indexes the capital basis for inflation. Bradley-Gephardt taxes capital gains in full without indexing. The first version of Kemp-Kasten resembled the Treasury treatment, except that we had a 25 percent instead of a 35 percent top tax rate on ordinary income and a 10-year transition period during which taxpayers could choose a 25 percent capital gains exclusion in lieu of indexing.

On reflection, we decided that there are two kinds of investors who must be considered, and that no single, simple treatment was likely to make them whole. The typical investor holds an asset for a long period and receives a fairly modest real rate of return; for this investor, indexing the capital basis is very important to avoid the taxation of capital as income, as was the case throughout the 1970s. However, the entrepreneur and the high-risk venture capitalist typically have a basis in an investment that is very low or even zero, and they seek a high real rate of return as the reward for successfully risking their capital. When a stock goes from 50 cents to 10 dollars, indexing the 50 cents does not help much. Taxing the gain as ordinary income, therefore, would penalize the risk-taker, especially if the top tax rate rises from 20 percent to 35 percent as under the Treasury plan.

We decided in our new bill to offer two permanent options. Under the current version of Kemp-Kasten, in any year, a taxpayer may elect to have his capital gains taxed as ordinary income with indexing, or else forgo the indexing and receive a 40 percent exclusion (or in the case of corporations, a reduced 20 percent alternative capital gains rate). With the 40 percent exclusion, the top marginal tax rate on capital gains would effectively be reduced from 20 percent to about 17 percent for individuals. I believe this approach is fair both to the ordinary investor and to the entrepreneur or venture capitalist.

Corporate Provisions

For business, all three major tax reform plans lower the corporate tax rate into the low 30s, and repeal the investment tax credit and

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many other corporate tax preferences. However, both Bradley-Gephardt and Treasury I move in the direction of depreciation according to the comprehensive income tax, under which write-off periods try to approximate the estimated useful lives of assets. This approach has been criticized by some for increasing the cost of capital for new investment, and for increasing the disparities in present values of depreciation allowances between short- and long-lived assets.

On the other hand, current law has been criticized because the combination of the investment tax credit and the Accelerated Cost Recovery System (ACRS) depreciation allowances enacted in 1981, when inflation was expected to continue in double digits, can result in an outright subsidy when the discount rate is low enough—that is, the capital cost can exceed the value of expensing when inflation is low. Yet at higher rates of inflation, capital cost recovery falls short of expensing, by amounts that increase with asset-class life. Part of this disparity comes from the fact that not all kinds of investment qualify for the investment tax credit. And because both ACRS and the investment tax credit are heavily "frontloaded," current law has also been criticized for lending itself to tax shelters based on up-front cash flow rather than economic value.

The first version of Kemp-Kasten kept the current-law ACRS depreciation, repealed the investment tax credit and most other corporate tax preferences, and lowered the top corporate tax rate to 30 percent, with a reduced 15 percent rate for small business earning below $50,000. This in itself went a long way toward removing the disparities in effective tax rates across industries and among different kinds of investments, while maintaining incentives for capital formation. However, we found a way to improve upon it.

The new version of the bill cuts the top corporate tax rate from 46 percent to 35 percent (with rates of 15 percent below $50,000 and 25 percent up to $100,000) and modifies the ACRS depreciation allowances into something we call the Neutral Cost Recovery System (NCRS). NCRS is designed to provide the present value of investment expensing without some of its practical problems. We keep the same asset classes as ACRS, but the write-off period is slightly lengthened and the total write-off is increased to include inflation indexing and a 3.5 percent real rate of return.

For example, the ACRS five-year class, which includes most business machinery, becomes six years, but the total write-off is increased from 100 percent of the initial cost to 110 percent plus indexing. Assuming 5 percent inflation, on a $1,000 investment a company could therefore write off $1,153 over six years instead of $1,000 over

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five years. Similarly, the three-year class for vehicles becomes four years and the write-off increases from 100 percent to 106 percent plus indexing; the 18-year class for real estate becomes 25 years and the total write-off is 148 percent plus indexing.

In each case the present value of the depreciation allowance is equivalent to expensing, assuming a 3.5 percent real rate of return on capital, which is approximately the postwar average. Kemp-Kasten therefore removes both the outright subsidy to new investment at low rates of inflation, and the bias against capital investment at high rates of inflation. A recent study by Bonilla (1985), for the Institute for Research on the Economics of Taxation (IRET), compared the neutrality of tax treatment of depreciable investment under various tax plans. According to Bonilla (p. 1):

> The inflation-indexed Neutral Cost Recovery System (NCRS) included in the Kemp-Kasten "FAST" proposal would much more nearly satisfy the inter-asset neutrality criterion, at any rate of inflation, than either RCRS [the Treasury plan] or ACRS-ITC [current law]. It would also effectively eliminate the prevailing income tax bias against investment in durable capital. It is an innovative approach to resolving the problem of the front-loaded ACRS-ITC without the adverse effects on the cost of capital in the RCRS [Treasury proposal].

Since the write-offs are stretched out, the plan avoids the up-front revenue costs of pure expensing; in fact, NCRS would raise corporate receipts for several years. Because capital cost recovery under Kemp-Kasten is "backloaded" compared with current law (after the first year, which uses a half-year convention, the write-offs are straight-lined in round percentages), NCRS and the sharply reduced marginal tax rates under Kemp-Kasten reduce the possibilities for tax shelter while increasing after-tax incentives for capital investment. This treatment effectively eliminates the double taxation of corporate income, eliminating the need for integration schemes which add to the complexity of the tax code. Finally, industries that face high effective tax rates under current law because they cannot take advantage of items like the investment tax credit will benefit substantially from the reduced corporate tax rates and increased present value of depreciation for plant.

Conclusion

Until now, the focus of tax reformers has been on the consensus which exists in favor of comprehensive federal tax reform to lower tax rates and simplify the tax code. The proponents of tax reform—Senators Bradley and Kasten, Congressman Gephardt and myself,

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the Treasury—have already begun working to achieve a good tax reform bill. Now that this consensus is clear even to opponents of tax reform, it is appropriate to focus on the details that will make for the best consensus bill in the Congress.

The name on a bill makes less difference than the contents. But I think that several elements in the Kemp-Kasten approach make it a good one. We do not claim that it is the last word in tax policy: in fact, we have introduced three successive versions precisely because we thought of ways in which it can be improved; we may do so again if we find it desirable. I have not exhausted the case for Kemp-Kasten, but I hope that I have outlined the philosophy behind it and some of its major advantages for American families, workers and savers, businessmen and entrepreneurs.

This is where would-be tax reformers must begin and end—with the lives of the people whose effort, thrift, and initiative represent the vital force of our economy. We have a chance that comes once in a lifetime, to alter the course of a policy which will fundamentally affect those lives for a generation or more. I am confident that this year Congress will rise to the challenge and enact a good tax reform plan.

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PRESIDENT REAGAN'S MODIFIED FLAT TAX: ANALYSIS AND COMPARISON

Manuel H. Johnson

Introduction

The present federal tax system is overly complex; is viewed as being unfair; and most important, it is the source of a multitude of costly economic inefficiencies. This situation prompted President Reagan, in his 1984 State of the Union Address, to instruct the Treasury Department to conduct a thorough review of the federal tax system.

The department under the direction of Secretary Donald T. Regan completed this initial task by issuing in November 1984 a three volume report entitled *Tax Reform for Fairness, Simplicity, and Economic Growth* (Treasury I). This report proposed a revised broad-based income tax.

The president, in his State of the Union Address on 6 February 1985, enumerated five major goals of tax reform and called for the preparation of an administration proposal to the Congress based on many of the principles contained in the initial treasury report. The five major goals are: (1) Tax reform should not result in a general tax increase; (2) the home mortgage interest deduction should not be jeopardized; (3) personal tax rates should be reduced by removing many preferences, with a top rate no higher than 35 percent; (4) corporate tax rates should be reduced and capital formation should be encouraged; and (5) individuals living at or near the poverty line should be exempt from income tax.

A revised tax plan was prepared by a treasury team led by James A. Baker III, the new treasury secretary, and on 29 May 1985 President Reagan issued his proposal to Congress entitled *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity* (Treasury II).

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As stated in the title, economic growth is one of the key goals of the president's tax reform proposal. This article discusses those features of the president's proposal that are expected to enhance economic growth. The proposal should:

- Increase employment by lowering the marginal personal income tax rates applied to labor income;
- Lower the overall cost of capital and expand investment by lowering the marginal personal and corporate income tax rates, improving the capital cost recovery system, and granting partial dividend deductibility;
- Eliminate the sheer economic waste caused by unnecessary inflation-related risk and uncertainty in the investment process by adjusting the capital cost recovery system for inflation; and,
- Produce a more efficient allocation of capital through more even tax treatment of various capital assets.

Section I sets out the theoretical advantages of lower marginal tax rates on labor, a reduced overall cost of capital, lower risk and more efficient allocation of resources. The section also provides the analytical framework which is needed to judge the efficacy of tax reform proposals in each of these four areas. Section II describes the specific provisions of President Reagan's proposal to deal with each of these areas. Section III contains some empirical estimates of the impact of the president's proposals on the economy. The economic literature is sampled for estimates of the impact tax changes in general might have on decisions affecting labor supply, saving, and investment. The use of econometric models in the evaluation of the president's proposals is discussed, and some results are presented. Finally, Section IV contains a summary and conclusions.

I. Taxes and Economic Efficiency

Any tax system diverts economic resources from their natural channels to government use. This enables the government to purchase a share of the national output which would have been put to other uses in the absence of the government spending. Ideally, the nation would employ the most efficient and evenhanded tax system in order to do this with the minimum damage to total economic output and employment.

Unfortunately, the current tax system moves the economy away from its natural patterns of production and consumption by more than is desirable or necessary to provide revenues and output for the government's needs. Consequently, output and employment are less

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than they otherwise would be. Also, consumers are needlessly steered away from products they might prefer, but which have been made more difficult to acquire by the tax system, and toward those products which might offer less satisfaction, but which have been made more readily available by tax preferences.

Prices normally tell the producer what the real cost of labor and capital inputs are and tell the consumer how much it costs society in terms of real resources to provide various goods and services. This information is essential if producers are to use resources efficiently and if consumers are to allocate their income most effectively and be charged appropriately for their use of scarce economic resources.

Taxes affect the prices firms must pay for labor and capital, and affect the rewards that the suppliers of labor and capital receive for their efforts. Taxes also affect the prices consumers must pay for the various products they buy. When taxes are levied unevenly across various types of labor or capital, or across various products, the price structure is altered. Market prices no longer accurately reflect the real cost of labor and capital, and firms are led to change the mix of labor and capital in inappropriate ways which result in lower total output nationwide. The relative costs of producing various goods and services are altered. The relative prices faced by consumers shift, and consumers are led to shift needlessly from one mix of purchases to another, with less satisfaction achieved for any given level of resources used up.

One of the important goals of the president's tax reform proposals is to identify and eliminate many tax-induced inequalities in order to restore the appropriate price relationships in the marketplace. It is a search for "economic neutrality" and optimal growth. Of course some tax distortions will remain after any reform effort, if for no other reason than some activities, such as nonmarket household production and the enjoyment of leisure, escape taxation altogether. Also, concerns over equity, fairness, and various social goals will continue to play a large part in the design of any tax system. This is perfectly proper, as long as the costs and benefits of various options are clearly presented and understood.

Distortion of Economic Choices By Taxes

A number of important economic choices are potentially impacted by taxes. In terms of consumption decisions, there is the choice between the consumption of produced goods and the consumption of leisure, and the choice between current and future consumption. On the production side, choices must be made regarding the mix of labor and capital inputs and, for a given amount of capital, the appro-

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priate asset structure. In addition, firms must decide on an appropriate mix of financing (debt versus equity) and on a legal form of organization (corporate versus noncorporate). Finally, for enterprises organized as corporations, there is a decision at the margin regarding the payment of dividends and the reinvestment of earnings.

Two General Biases: Leisure vs. Labor, Consumption vs. Saving

The household sector must decide how to allocate the time available to it. Time may be spent directly on leisure. Time may also be used to furnish labor to the marketplace to earn wage and salary income for the purchase of market goods and services. A tax on earned income raises the time-cost of acquiring market goods and services relative to the time-cost of leisure, and encourages the consumption of leisure.

The term "leisure" can be interpreted rather broadly as any available alternative to the most productive market use of labor services. Thus a bias toward leisure can lead to a less motivated and less productive workforce, an increase in do-it-yourself labor, an increase in illegal cash transactions, and greater employment search. The result may include higher labor turnover and higher measured unemployment, lower labor productivity, and less employment. This bias can be reduced, but not eliminated, by lowering the tax wedge through lower marginal tax rates.

Once the household sector decides on the amount of market earnings it desires, it has a second choice to make. It must decide whether to use the income for immediate consumption, or to defer the purchase of consumption goods to the future. That is, the household must decide whether or not to save through financial assets to earn interest, or to invest directly in structures or equipment to earn profit, in order to augment future consumption. Interest and profit are the rewards for consuming in the future rather than in the present. The income tax on interest, dividends and profit, and other tax provisions affecting capital, raise the cost in terms of forgone current consumption of acquiring additional future consumption. In other words, saving/investment is discouraged. The capital stock is smaller and less modern, and future income levels are lower than under a more neutral tax system. Individuals trade away a higher level of future income for a higher level of current consumption.

Ideally, the tax system should be neutral with respect to consumption and investment. In other words, the imposition of taxes should not cause more or less consumption or investment to be picked than in the case of no taxes. This bias can be reduced, but not eliminated,

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through lower marginal personal and corporate tax rates and more complete capital cost recovery.

Complete elimination of this bias is possible, but it would require that income be taxed only when consumed. Income saved and the earnings on savings would have to be tax deferred, and capital investment would have to be expensed instead of depreciated over time. This would require a substantial shift in U.S. tax policy, from an income-based tax to a consumed income-based tax. This is impractical under the combined constraints of revenue neutrality and a desire to maintain approximately the current distribution of the tax burden on equity grounds. Nonetheless, it is possible to reduce the distortion by applying a portion of the revenue raised from elimination of special deductions and credits to lower marginal personal and corporate tax rates, and improve the depreciation schedules relative to current law.

Thus, there are two general biases in the income tax due to relative price distortions. The first is the bias against earning income for consumption of all types of market goods and services in favor of leisure. The second is an added bias against saving/investment for future consumption in favor of current consumption.

Specific Distortions

In addition to the general distortions described above, the uneven tax treatment under current law of various types of capital assets creates thousands of specific distortions which can lead to inefficient use of capital and reduced output. The tax system affects the choices business makes among different investments and alters the mix of the capital stock. Ideally, a tax system should be neutral with regard to the selection of various types of capital. Bias can be introduced when tax depreciation does not coincide with the actual way in which the capital asset loses value. This notion has led to the view that if you set tax and economic depreciation equal and exclude capital gains from tax, a single rate of tax on the remaining income would treat capital neutrally.

Improvements in tax rate neutrality cause businesses to change their mix of factors of production toward those previously less favored factors. These less favored factors had to have yielded a higher return than others to offset the tax bias. Therefore, as the mix changes, the more productive assets are increased and the less productive are decreased. Therefore, the same level of aggregate stock yields a larger output.

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II. President Reagan's Proposals for Efficiency and Growth

Economic efficiency and growth are furthered by four basic features of the president's proposal: lower marginal income tax rates; a lower and more neutral effective tax rate on capital as a whole; a more predictable treatment of capital in the presence of inflation; and more uniform treatment of all sources and uses of income across assets and activities.

Lower Tax Rates

The president's proposal would reduce marginal federal individual income tax rates by an average of 19 percent. The statutory marginal tax rate, weighted by the families' economic income, would fall from 23.6 percent under current law to 19.1 percent under the president's proposal. The top individual tax rate would be reduced from 50 percent to 35 percent.

The proposal would also reduce the top marginal tax rate on corporate income from 46 percent to 33 percent, lower the maximum capital gains tax rate from 20 percent to 17.5 percent, and retain graduated corporate tax rates for small businesses.

More Uniform Tax Treatment of Income

The current U.S. income tax provides uneven treatment to a long list of economic activities through exclusions from income subject to tax, adjustments to income, business deductions unrelated to actual expenses, deferral of tax liability, deductions for personal consumption expenditures, tax credits, and preferential tax rates.

The president's proposal would reduce some of the non-neutrality of the taxation of various forms of labor income. Reductions in marginal tax rates reduce the differentials between favored and nonfavored types of labor income. Moreover, some types of fringe benefits which currently are excluded from tax would be taxed similar to wage and salary compensation. The proposal would also increase work incentives by increasing the net gain from working relative to the return from certain wage replacement programs, the benefits from which are currently excluded from tax.

The president's proposals would address particularly the non-neutrality of capital and business income taxation. Under current law the effective tax rates applied to income from depreciable assets vary widely across assets and across industries. First, the current depreciation schedules and investment tax credit (ITC) provisions treat some types of assets more favorably than others. Second, because

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depreciation allowances are based on historical costs, the real value of depreciation allowances and effective tax rates vary with inflation, and vary differently with inflation depending on the different lengths of life of various assets. As a result, the current tax system favors industries that invest more in equipment over those that wish to invest more heavily in inventories, land, structures, or entrepreneurship and innovations; and it discriminates against economic activity conducted by corporations. Moreover, the extent of these distortions depends on the inflation rate, with long-lived assets suffering the most from inflation.

The proposed Capital Cost Recovery System (CCRS), which is indexed for inflation, in conjunction with repeal of the investment tax credit and other business tax preferences, would produce more nearly uniform effective tax rates and therefore would be less distortive of economic choices among new investments in equipment, structures, land, and inventories. The variance of effective tax rates across different industries and assets would be minor compared to the unsystematic distortions occurring under current law. The lower cost of new capital investments in structures, land, and inventories would more than offset the higher cost of capital investments in equipment. Thus, the president's proposal would produce both a lower cost of capital for new investment and more uniform effective tax rates than current law. Because CCRS is indexed for inflation, the cost of capital and effective tax rates would not vary with inflation, as under current law.

The president's proposal would also make tax shelters less attractive and eliminate many de facto spending programs which are hidden in the tax code. The proposal would reduce the attraction of investments which are undertaken solely because of tax differences, thereby freeing funds for more productive investments. Tax shelters would be made less profitable first, because marginal tax rates would be reduced. Reduction in rates automatically would reduce the differentials between sheltered and nonsheltered activities. In addition, shelters would be attacked directly through extension of the at-risk rules to real estate, limitation of interest deductions other than for the principal residence, and matching of expenses and receipts in multiperiod production. Repeal of the panoply of credits and other tax preferences in exchange for lower, more neutral tax rates would reduce the extent of federal government intrusion into private economic decisions.

Finally, the president's proposal would establish the principle of relief from double taxation of dividends with a 10 percent deduction for corporate dividends paid, and would begin to alleviate the adverse

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economic effects of double taxation of income. Currently, corporate income that is distributed as dividends is subject to tax twice, first at the corporate level and again when received by individuals. The double taxation of dividends encourages corporations to rely on debt relative to equity finance, provides an incentive to retain earnings rather than pay out dividends, discourages capital formation, and is an impediment for use of the corporate form by businesses.

III. Estimated Impact of President Reagan's Tax Reform Proposals

The Treasury's estimates of the economic impact of the president's tax reform proposals involved three separate evaluations. First, an assessment of the proposed provisions on effective tax rates and the cost of capital was undertaken to determine the extent of rate reduction and tax neutrality. Second, a review of the statistical evidence on responsiveness of the economy to lower marginal tax rates and more neutral tax treatment of income from capital was conducted. And finally, macroeconomic model simulations were examined, including the Treasury's own efforts.

Effective Tax Rates and the Cost of Labor and Capital

Tables 1, 2, and 3 below summarize the Treasury's estimates of changes in tax rates and the cost of capital due to the president's proposals. Table 1 shows the average marginal tax rates on wage and

TABLE 1

MARGINAL TAX RATE COMPARISONS: WAGE AND SALARY INCOME

Income Category	Marginal Tax Rate[a]		
	Current Law	President's Proposals	Percentage Change
All Wage and Salary Income	24.6	20.9	−14.8
Wage and Salary Income of Second Earners	24.4	22.1	−9.5

[a]These marginal tax rates relate to the additional federal income taxes that would result from a 1 percent across-the-board increase in wage and salary income. Included in the estimates under present law is an offset for the taxes paid and two-earner deductions which would increase as incomes increase. A weighted average of statutory marginal rates yields a −19 percent change in rates from current law under the president's proposals.

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salary income that would prevail under the president's tax plan compared with tax treatment under current law. The marginal rates shown in Table 1 relate to the added federal income taxes that would result from a 1 percent increase in wage and salary income. For all wage and salary income the marginal tax rate would decline about 15 percent. The marginal rate on second-earner wage and salary income would decline almost 10 percent. Therefore, even with repeal of the two-earner deduction proposed in the president's plan, the marginal tax rate on second earners still declines considerably. A simple weighted average of the statutory marginal tax rates would show a 19 percent decline from current law tax treatment due to the president's plan.

Table 2 shows comparisons of combined personal and corporate effective tax rates on income from capital investment. As shown, effective tax rates on capital under current law tax treatment are high, except for equipment, and are quite uneven across types of capital. However, under the president's proposals, effective tax rates are lower for all types of capital, other than equipment, and the rates are considerably more neutral across capital assets. The weighted average effective tax rate on all capital would decline by about 20 percent under the president's tax plan. Although the proposed repeal of the investment tax credit would increase the effective tax rate on equipment, it would also bring the rate closer into line with the tax rates associated with other types of capital investments. The president's inflation indexation plan for depreciation and inventories, his corporate and personal income tax rate reductions, and his 10 percent dividend deduction all combine to significantly reduce the effective tax rates on structures and inventories.

TABLE 2

EFFECTIVE CORPORATE AND PERSONAL TAX RATE COMPARISONS: CAPITAL INVESTMENT INCOME

Asset Category	Effective Tax Rate[a]		
	Current Law	President's Proposal	Percentage Change
All Capital	51	41	−19
Equipment and Structures	47	39	−17
Equipment	21	35	66
Structures	54	40	−26
Inventories	59	46	−22

[a]For an explanation of the methodology and assumptions used for these calculations see the footnotes to Table 7.01–12 in Treasury II (1985, p. 158).

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Clearly, it would be desirable for the purposes of investment and potential economic growth to neutralize effective tax rates at even lower levels. Unfortunately, the budgetary consequences of such action preclude further movement in this direction. If federal spending growth can be reduced in the future, it might be possible to make further inroads toward lower and more neutral capital taxation.

Many representatives from the business community have demonstrated concern over the proposed repeal of the investment tax credit for equipment; however, it has been well documented that this provision has contributed substantially to the unevenness of effective tax rates on capital.[1] A recent study by Tannenwald (1982) found that 28 percent of the decline in the share of investment accounted for by structures could be attributed to the tax bias in favor of equipment. One of the results of this tax bias has been a trend toward rising depreciation as a percent of total investment as the average tax life of capital shortens and more capital consumption allowance is taken. In other words, less net investment is generated for each dollar of gross investment. Therefore, a reduction in the effective tax rate on structures and inventories along with repeal of the investment tax credit will help neutralize the tax bias between capital assets. This change should, over time, lengthen the average life of capital as investment is more efficiently distributed toward structures.

Table 3 shows comparisons of capital service prices between current law tax treatment and the president's proposals. The service price is a cost-of-capital measure that reflects the required percentage rate of return from an investment necessary to cover all its associated costs and generate a normal profit. Treasury estimates indicate that the weighted average cost of all business capital would decline by about 3 percent under the president's tax plan relative to current law. Although the cost of equipment would rise somewhat due to repeal of the investment tax credit, the cost of structures and inventories would decline by enough to produce a moderate decline in the overall cost of new investment.[2]

The Effect of Taxes on Saving, Investment, and Labor Supply

The positive economic impact of the president's tax reform plan is based on the two principles of lower marginal tax rates and more neutral taxation of income. Lower marginal tax rates on both labor

[1]For example see Kopcke (1981a, 1981b), Corcoran (1981), Mauskopf and Conrad (1981), and Tannenwald (1982).

[2]A detailed explanation of the methodology and assumptions used for the calculations in Table 3 is available from the author.

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TABLE 3

CAPITAL SERVICE PRICE COMPARISONS

Asset Category	Capital Service Price (%)[a]		
	Current Law	President's Proposals	Percentage Change
All Capital	13.1	12.7	−3.1
Equipment and Structures	14.1	13.9	−1.4
Equipment	17.8	18.9	6.1
Structures	12.1	11.3	−6.6
Inventories	8.7	7.0	−19.5

[a]The service price or user cost calculated for each asset category represents the current marginal product required per dollar of corporate investment in that category. Since an asset's relative productive efficiency over future periods is assumed to be independent of other variables, the current period's marginal product summarizes the before-tax returns that can be expected over the life of the asset. Thus, the service price provides a measure of the before-tax returns required to be produced by an asset in order that anticipated taxes, replacement costs, and a (risk inclusive) "normal" rate of return are covered. The normal real rate of return is assumed equal to 4 percent.

and capital should increase incentives for work effort, saving, and investment and, therefore, improve the overall performance of the U.S. economy. Taxing income more evenly should reduce the misallocation of resources due to the tax code and produce efficiency gains that will improve the economic growth potential of the United States.

1. Income and Substitution Effects from Tax Changes. Increases or decreases in income tax rates change net-of-tax wage rates which in turn provides both an income effect and a substitution effect on an individual's choice between work and leisure, and between consumption and saving. For example, a decrease in the net-of-tax wage rate (that is, a tax increase) normally induces a substitution of leisure for work on the one hand and an income effect favorable to work effort on the other. Conversely, an income tax rate cut increases the net-of-tax wage rate and provides a substitution effect that is favorable to work effort and an income effect that favors leisure over work. The totality of these effects on the choices by all individuals helps determine the total labor supply and the total amount of savings available for new capital formation.

Ture (1982) and Gwartney and Stroup (1983) have shown that an income tax cut in the aggregate results in no net income effect (that is, a substitution of leisure for work), so that the substitution effect induces more work effort. An income effect may be induced for an

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individual but this is not possible in the aggregate because the level of real government extraction remains the same.

2. *Savings.* Empirical evidence supports the view that changes in tax rates influence saving decisions. In a 1978 article Boskin reported that his estimates led him to conclude that private saving is strongly affected by changes in the real after-tax rate of return: the estimated elasticity of private saving is around 0.3 to 0.4. Colin Wright (1969) estimated that the interest elasticity of saving ranged from 0.18 to 0.27.

Analysis by Lawrence Summers (1981) showed that a realistic life-cycle saving model demonstrates that for a wide variety of plausible parameter values savings are very interest elastic. The long-run responsiveness of saving to changes in the net interest rate can be as large as a 19 percent increase in saving for a 10 percent increase in the after-tax interest return or an interest elasticity of the savings rate of about 1.9.

3. *Investment and Efficiency Gains.* Tax policy has an influence on investment decisions because of its effect on the service price or user cost of capital. Taxes on capital also have an effect on economic efficiency because of their impact on the allocation of resources.

If the elasticity of substitution between capital and labor is large, tax policy could be used to alter (increase) the capital-output ratio through changes (decreases) in the after-tax service price of capital. In a recent study, Hendershott and Hu (1981) found that changes in the user cost of capital, as well as expected sales, have an effect on the relative mix of capital and labor. They found that if nothing else changed, cutting tax service lives of equipment in half and allowing the same amount of depreciation deductions would have increased the desired equipment stock in 1978 by almost 14 percent. One-half of this increase would have taken place within eight years.

Their conclusion about the timing pattern reflects the finding that once capital is put in place, factor proportions are not quickly altered in response to changes in the user cost of capital, but rather the mix of capital and labor is changed gradually as the old capital is depreciated. Therefore, accelerated depreciation should help speed up the adjustment process if it works to lower the capital service price.

Other studies using a high elasticity of substitution between capital and labor have concluded that substantial increases in investment could be achieved through reductions in taxes and the service price of capital. A study by Sinai and Eckstein (1981), for example, concluded that a 10 percent change in the service price of capital would increase gross investment as a share of GNP by 0.5 percentage points

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during the 5-year period following the change in tax policy. Hall and Jorgenson (1967) calculated the effects of changes in tax depreciation policy in 1954 and 1962 and the passage of the investment tax credit in 1962 and concluded that the effects on service prices and investment were "very substantial." For example, as a result of the 1954 changes in tax depreciation, the authors concluded that over the period 1954 to 1963 nearly 17 percent of the net investment in manufacturing equipment, 19 percent of the net investment in nonfarm, nonmanufacturing equipment, and 21 percent of net investment in structures could be attributed to the change in service prices due to the depreciation rules. Equally favorable results were observed for the other depreciation rule changes studied.

Sinai, Lin, and Robins (1983) concluded that changes in the tax treatment of capital have a significant effect on business investment. Their analysis showed that without the tax incentives of the Economic Recovery Tax Act of 1981 business fixed investment, in real terms, would have increased only 3.3 percent in 1981 and declined 5.6 percent in 1982 rather than the 3.5 percent and −3.6 percent that actually occurred. Furthermore, the ACRS and ITC helped prevent business capital outlays from declining as much as might have been expected because of the 1981–82 recession: in 1981 and 1982 investment was $0.6 billion and $3.9 billion more, respectively, than otherwise would have been the case. Their projections indicated that for 1983 to 1985 the net effect of the 1981 and 1982 tax changes in business investment would have been an additional $9 billion to $17 billion a year.

Meyer (1984) and Ott (1984) also found that the net effect of the 1981 and 1982 tax act changes was to make investment more attractive by reducing the net cost of capital compared to what it would be under 1980 tax law. Meyer noted, for example, that these tax changes contributed significantly to the fact that business investment in equipment in general grew at nearly a 22 percent annual rate during the first 18 months of the current economic expansion or twice as fast as the average growth rate of equipment investment during the same period in six previous expansions and faster than any other expansion during the post-World War II period. Ott noted that the sharpest rise in capital stock growth in any single year occurred in 1983.

Changes in tax rates that induce increased savings could also have an effect on investment decisions. Increased saving would help lower interest rates which would reduce the service price of capital. A lower service price of capital would encourage an increase in investment.

The primary objective of economic policy should be to maximize the total wealth of the nation. This maximization can be achieved

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only if resources are allocated in the most efficient way possible. Taxes on capital and labor can distort the allocation of resources unless they are levied so as to be neutral in their impact on work and leisure and on saving/investment and consumption. In the case of investment, discrepancies (that is, non-neutrality) in the tax treatment of different types of assets reduce the efficiency of capital allocation. This in turn reduces the nation's wealth below what it otherwise would be if taxes on capital were neutral.

Several econometric studies have measured the loss in efficiency from tax systems that are not neutral in their impact, that is, when some assets are treated less equitably than others. For example, Piggott and Whalley (1977), in their analysis of taxes and subsidies in Britain, suggested that around one-quarter of net revenues raised by government each year are forgone through the deadweight loss associated with the tax subsidy system. Replacing such a tax system with a "yield-preserving" neutral sales tax or some other more neutral system would produce sharp distributional gains.

Ballard, Shoven, and Whalley (1982) also concluded that a tax system that is not neutral results in considerable loss of welfare. The authors estimate that welfare losses per extra dollar of revenue raised from existing tax distortions in the United States may approach a dollar. That is, including the loss of welfare, the cost to the private sector of one dollar of taxes is almost two dollars.

In an earlier study Shoven (1976) also concluded that there is a significant loss of efficiency as a result of a non-neutral tax treatment of capital. His estimate of the loss amounted to between 6 percent and 15 percent of the revenue generated by a surtax on capital income originating from the "corporate" sector.

A major objective of the Reagan administration tax program was to reduce the efficiency losses resulting from high and non-neutral tax rates on capital and labor and thereby increase economic growth, output, income, and employment. In a recent study Jorgenson and Yun (1984, pp. 45–46) concluded that "income from business assets receives much more favorable treatment under the Reagan program than under previous tax policy." Simulating the U.S. economy under the Reagan program and under prior policy, the authors concluded that the gain in potential welfare under the program amounts to as much as 3.5 to 4 percent of the 1980 private national wealth, depending on which budget alternatives are assumed. By way of comparison, under a lump sum tax adjustment, neutralizing the tax treatment of capital completely through expensing of investment expenditures and the elimination of sales taxes on investment goods result in a potential welfare gain to the economy of more than 43 percent of

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U.S. private wealth in 1980. Clearly, these results show that a tax system that provides effective tax rates which are the same for all assets would produce a more efficient allocation of capital resources and a substantial increase in national wealth.

4. Labor Supply. As stated in the introduction to this section, an income tax rate reduction has a positive effect on labor supply growth. Empirical studies clearly indicate a positive impact. Taking into account the net substitution and income effects of taxes on labor supply Moffit and Kehrer (1981) concluded that the range of substitution elasticities for females has been as high as 1.2 and the income effect has varied between −0.06 and −0.81. Fullerton (1982) reported that the overall weighted-average elasticity for men and women together was 0.15.

In recent studies Hausman (1980, 1981) found that the combination of federal and state income taxes and the payroll tax leads husbands to reduce their work effort by about 8 percent. He also found that these taxes impose significant deadweight losses (equivalent to 22.1 percent of tax revenue collected) that could be reduced significantly by replacing the present mix of progressive personal income taxes and payroll taxes with a more proportional income tax or an income-type, value-added tax.

Macromodel Estimates of the Impacts of Tax Reform

The major macroeconometric model forecasting firms have made estimates of the impacts on the economy of the president's tax reform proposal. Considerable significance has been attached to these assessments, and they received substantial attention in the press. Table 4 summarizes the results of three of the leading macroeconometric firms. (Results are in terms of differences in levels from the baseline, no-reform paths from which the simulations were constructed.)

Most striking among the results are the relatively minor impacts calculated by these analysts and their models. For 1994 Wharton finds zero impact on real GNP, while Data Resources estimates that real activity would be 0.1 percent lower than would occur in the absence of tax reform.

Among other findings there was general agreement among the model operators that the tax reform proposal would result in a modest shift in the composition of real GNP away from business capital spending and toward consumer purchases. Beyond these, there were some notable differences among the model results—slightly lower unemployment rates for Wharton but higher rates for Data Resources,

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TABLE 4

ESTIMATED IMPACTS OF PRESIDENT REAGAN'S TAX REFORM PROPOSAL COMPARED TO BASELINE SOLUTIONS

Forecast Variable	Macroeconometric Models				
	CHASE (1986–90)	DATA RESOURCES (1986–89)	DATA RESOURCES (1990–95)	WHARTON (1986–89)	WHARTON (1990–94)
Real GNP (% diff.)	0.0	0.5	0.2	0.3	0.2
GNP Deflator (% diff.)	0.0	0.0	0.6	0.0	0.8
Real Business Fixed Investment (% diff.—total)	NA	−0.4	−0.9	−1.4	−2.3
Structures	−6.9	1.8	1.4	−1.6	−2.6
Equipment	−2.1	−1.3	−1.8	−1.0	−1.6
Real Personal Consumption (% diff.)	NA	1.0	0.9	1.1	1.2
Housing Starts (millions of units)	0.02	−0.08	−0.05	−0.16	−0.15
Personal Saving Rate (% point diff.)	0.2	0.4	0.4	0.4	0.2
Real Net Export Balance ($ billions)[a]	0.6[b]	−2.0	−5.6	−0.4	−0.7
Interest Rates (3-mo. T-bill) (% point diff.)	−0.5[c]	0.1	0.4	0.0	0.2
Federal Budget Surplus (Deficit) ($ billions)	9.0	1.0	−19.0	−11.0	−5.0
Employment (% diff.)	NA	0.3	0.2	0.2	0.5
Unemployment Rate (% point diff.)	0.0	0.0	0.1	−0.2	−0.4

[a]In 1972 dollars.
[b]Nominal.
[c]By assumption.

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lower interest rates for Chase (by assumption entered exogenously into the model) but higher rates for the other two. Estimates of the impact on the federal deficit varied widely.

Problems with Model Assessments

The impacts on the economy of the provisions of the tax reform proposal are primarily micro in nature—they relate to reactions of individual economic units such as the household or firm, and their estimation requires the types of analyses and calculations taught in a course in micro- not macroeconomics. The macroeconometric models, though becoming increasingly large and complex over the years, do not generally incorporate mechanisms that permit direct estimation of the economic effects of tax reform proposals. Rather, calculations of these effects must be made on the side and then entered exogenously into the models. Thus, when used to assess impacts of tax reform proposals, the models largely are mechanisms for calculating feedback and secondary impacts of these exogenously entered changes. In some cases, there may be little empirical evidence available, as a particular reform proposal may have no precedent in U.S. experience.

For years in the wake of the "Keynesian revolution" such issues were largely neglected as researchers directed their attention at more macro-type questions. Only more recently have these issues begun to receive the attention they deserve.

Model Simulations by the Treasury

Though skeptical as to the usefulness of the large macromodels in addressing the issues raised by tax reform, as a matter of completeness and to gain any insights that might be uncovered, the Treasury did conduct a number of model simulations of variants of the tax reform proposal and of specific elements that went into the final proposal. The results of two such experiments are outlined below. They shed light on the value and reliability of such models. They were conducted on a large model made available to customers by one of the leading private forecasting firms.

The first experiment was built on a simulation previously made by the private firm of the Treasury I (1984) tax package. It was conducted on a version of the model that has since been phased out and replaced by the firm. In the experiment, that earlier simulation was modified to incorporate most of the changes that went into the administration's final tax reform proposal (Treasury II 1985). However, this simulation was preliminary in that it did not contain all of the elements of the

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final package—it did not incorporate the recapture provision and depreciation schedules that were subsequently modified very slightly.

The simulation was modified in the following four ways: (1) side calculations were made of changes in the user cost of capital terms resulting from the shift from the original Real Cost Recovery System (RCRS) to CCRS; (2) side calculations were made of the changes in corporate depreciation flows which would result from the shift to CCRS from RCRS; (3) corporate and personal tax series were add-factored for differences between the November 1984 and the final tax packages, and other modifications were also entered (for example, to incorporate the shift from a 50 percent to a 10 percent dividend credit); and (4) the model was solved using a search routine to hold the path of money supply roughly constant across simulations (the same sort of procedure that the forecasting firm had followed in developing the original simulation).

Results of this experiment are summarized in Table 5. These estimates are in terms of differences from the no-tax reform base simulation. As the table shows, real GNP was estimated to be 1.6 percent greater by 1995 than the baseline without tax reform. Also, business investment was projected to increase 4.5 percent from the no-reform baseline by 1995. This simulation implied a moderate shift away from consumption toward more capital formation.

TABLE 5

RESULTS OF TREASURY DEPARTMENT SIMULATION WITH A LARGE MACRO MODEL

Forecast Variable	Average for Period 1986–90	1991–95	1995
	Percentage Difference from Base		
Real GNP	0.3	1.2	1.6
GNP Deflator	−0.3	−1.1	−1.1
Real Business Capital Spending	−1.2	2.5	4.5
Housing Starts	−5.2	1.5	−0.7
	Difference from Base		
3-mo. T-bill Rate (% pts.)	−0.4	−1.1	−0.4
Federal Surplus (Deficit) ($ billions)	−17.9	−6.4	−10.6

The second experiment was based on a new version of the same forecasting model—a version believed to more adequately contain many of the mechanisms for translating changes in the tax structure into impacts on the economy. In reviewing this new version of the

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model and using it to simulate various aspects of the tax plan, several problems were uncovered:

- In simulating what might happen if the recapture provision was dropped, it was discovered that interest rates were raised and the economy adversely impacted quite severely by a shift in saving from the federal to the business sector (an increased deficit and larger corporate cash flow) even though the total volume of domestic saving was basically unchanged. (The previous version of the model tended to give the opposite results.)
- Equations for multifamily housing treated these units as if these were all owner-occupied—deductibility of state and local property and income taxes would be completely lost by enactment of the tax proposal. In actuality, a substantial portion of these such units are owned and operated by businesses, which would retain deductibility.
- Inventory investment equations did not contain a mechanism to capture impacts of the reduced carrying costs that would result from the tax plan, nor had side adjustments been made for impacts of lower carrying costs.
- Based on side calculations, corporate after-tax profitability and stock prices were reduced over the next five years due to tax reform provisions. It might be argued that this perspective is incorrect since there is a partial windfall on after-tax earnings to owners of current capital, even with the recapture provisions, and also because rates of return should rise slightly, according to Treasury calculations in Table 3.

To correct these seeming deficiencies, an experiment was run with the model. The negative add-factors to stock prices were reduced, based on the assumption of a longer time horizon in profitability calculations. Based on side calculations and using model parameters in those calculations where possible, multifamily housing starts and inventory investment were add-factored upward. Finally, and not a fully satisfying resolution to problems created by the erratic response from the interest rate equations, the model was solved with a search routine to hold short-term interest rates roughly constant.

The results of this experiment are shown in Table 6. As in the previous Treasury simulation, real GNP and business investment both improved moderately relative to the no-reform baseline.

Other analysts might find fault with other assumptions incorporated into the original model simulation or with the specifications of the model. Some might reject the entire approach out of hand. Others might find reason to reject the modifications the Treasury entered

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TABLE 6

RESULTS OF TREASURY DEPARTMENT EXPERIMENT WITH A LARGE MACRO MODEL

Forecast Variable	Average for Period 1986–90	1991–95	1995
	Percent Difference from Base		
Real GNP	0.9	0.7	1.0
GNP Deflator	0.3	1.6	1.9
Real Business Capital Spending	0.2	0.1	1.1
Housing Starts	−1.3	−0.7	0.0
	Difference from Base		
3-mo. T-bill Rate (% pts.)	0.0	0.0	0.0
Federal Surplus (Deficit) ($ billions)	10.8	4.2	5.3

into the model. These results are presented as illustrative of the types of problems that must be addressed in using these large models to simulate changes in the tax structure. It is reemphasized that these modifications do not address the larger issue of whether econometric models can incorporate efficiency gains into simulations and capture the full flavor of benefits that would flow from reduced marginal tax rates.

IV. Summary and Conclusions

The pro-growth effects of the president's tax reform plan are based on the principles of lower marginal tax rates and more neutral tax treatment of income. Lower marginal tax rates on labor and capital should improve labor supply, saving, and investment. Treating income more neutrally with respect to federal taxation should enhance efficient resource allocation and increase the economic growth potential of the United States.

In the view of the Reagan administration, in general, and the Treasury, in particular, the implementation of the president's tax plan would unambiguously benefit the overall economy. While it is impossible to predict with any accuracy how quickly the economy would adjust to the proposed tax system, it is clear that when fully adopted, U.S. economic potential would be greater.

Tables 1, 2, and 3 above clearly show that tax rates on income from labor and capital would be reduced under the president's proposals and that income from various types of capital would be taxed more neutrally. In order to verify that lower and more neutral tax rates

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have positive effects on economic growth one need only to sample the professional research on the subject. Although there is a great deal of variance among researchers concerning the degree of responsiveness of the economy to lower and more neutral tax rates, the evidence is overwhelming that the net effect is positive. Rather than provide specific point estimates of the performance of the economy under the president's proposed tax program, this article contains estimates from the professional economic literature that can support a range of positive economic growth possibilities.

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THE FLAT TAX, NEGATIVE TAX, AND VAT: GAINING PROGRESSIVITY AND REVENUE

E. Ray Canterbery, Eric W. Cook, and Bernard A. Schmitt

Overview of Current Tax Reform Proposals

The ubiquitous attack on the federal income tax system has accelerated in recent years. Even economists no longer believe that modest alterations in the present system will suffice. Tax reform has come to mean a complete overhaul of a system riddled with holes. The four tax reform proposals that have received the most attention are the Fair tax (H.R. 3271, S. 1421), introduced by Senator Bill Bradley and Congressman Richard Gephardt; the Fair and Simple (FAST) tax (H.R. 6165, S. 2948), introduced by Congressman Jack Kemp and Senator Robert Kasten; Treasury I, the U.S. Treasury's tax simplification proposal; and Treasury II, the White House's modified version of Treasury I.

The present income tax is held in disrepute because it violates five basic principles of taxation:

1. The tax system should be fair, sufficiently fair to encourage compliance. Horizontal fairness, an idea that dates to Plato, requires taxpayers with the same incomes (regardless of sources) to pay roughly the same amount of tax. Vertical fairness would have taxpayers with higher incomes paying more tax than those with lower incomes. Virtually everyone agrees with these notions of fairness except apparently those special interest groups who try to control tax legislation.

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2. The tax system should be simple and understandable to the taxpayer. The personal income tax was sufficiently complex in 1983 that $3 billion was spent on tax preparation. This may explain why H & R Block opposes tax reform.
3. The tax system should have a broad base. Tax reformers, beginning 40 years ago with Henry Simons at the University of Chicago, have argued for a broad tax base. The reason is as simple as tax simplification: the broader the tax base, the lower the tax rates required for a targeted revenue.
4. The tax system should impede as little as possible the long-run allocation of resources: this is the economic efficiency principle. Today, the well-to-do family and the corporation are at least as much concerned with what an investment will do to their taxes as they are with what it will do for production. Today, tax preferences, which generally take the form of tax expenditures, are so pervasive that they exceed the amount of revenue generated by the income tax system.
5. The federal tax system should contribute to economic stability by cushioning swings in consumer and business incomes from the business cycle. Tax revenues that decline more rapidly than incomes during recessions and rise more rapidly during expansions cushion such swings in income.

In the three decades ending in 1979 the tax system adequately funded the federal government. This is so even though the federal revenue-to-spending ratio dropped to about 91 percent during the 1970s. This latter decline is largely attributable to deep recessions during the Nixon and Ford administrations. If one uses forecasts from David Stockman, who until recently headed the Office of Management and Budget (OMB) and was notorious for his overoptimism, the federal revenue-to-spending ratio will remain at only 80 percent from fiscal 1985 onward, even with strong economic growth. Will any of the major tax reform proposals alter this future? Regretably, they will not because they are all designed to be revenue neutral, and (without tinkering) would not generate any more revenue in 1985 than the present system.

Despite its other faults the present income tax has considerable vertical equity; it is progressive in structure since the average tax burden rises with income. Those with the highest incomes receive the greatest benefits from a stable, democratic government and from the free enterprise system. It is poetic justice that those who benefit the most in terms of the government's nurture and preservation of wealth should pay the highest tax rates. There are those who contend

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that all taxation is a burden. Let there be no mistake about it; it is, but such antagonists (or anarchists) miss the point. Unless the federal government enforces contracts and deters crime against property, develops and maintains a national system of communications and transportation, guarantees a nationwide system of education that provides a skilled labor force for industry, stabilizes the economy, regulates trade, and protects factories from foreign enemies, individuals and businesses will not be able to utilize fully their capacities for earning incomes. Taxation is a burden that individuals agree to share in order to maintain the necessary infrastructure for corporate enterprise and a free society. No political theorist ever said that government enterprise was a free lunch or that it should be. A plane cargo without an airport, a truckload of personal computers halted by a collapsed bridge, a factory bombed by the enemy, or an information industry dependent upon illiterates are all useless.

With respect to fairness, all of the aforementioned reform proposals are generally less progressive in nominal terms than the present system. In particular, the FAST tax, the flattest of them all, would shift some of the relative tax burden to middle-class taxpayers because low- and high-income taxpayers would receive a larger relative tax reduction.

Irrespective of the relative importance of tax simplification, its limits are set by the necessity to tax net rather than gross income. All of the major tax reform proposals would simplify and broaden the tax base by eliminating many tax preferences. However, exclusions such as the personal exemption that are available to most taxpayers and serve important goals are retained. As a general principle, the tax code can only be "as simple as possible," given potential conflicts with other important goals of the tax code.

An Alternative Proposal: FLANVAT

This proposal—for a flat, negative, and VAT tax system (FLANVAT)—is a combination of a modified flat-rate system of federal income tax reform for individuals with an income-based refundable tax credit (FLAN) and a value-added tax (VAT).[1] The FLAN reform program replaces the multi-bracketed tax-rate structure for individuals with three tax rates, which range from 10 to 30 percent, and applies these rates against a substantially broadened tax base. This part of the program is structured so that it would not significantly

[1]The overall configuration of this proposal first was presented in Canterbery (1983). Additional detail was provided in Canterbery (1984). The present paper elaborates the specific characteristics of the proposal and provides a quantitative analysis of its impact.

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change total tax liabilities, total federal expenditures, the distribution of tax liabilities, or federal expenditures among income classes (though such could be done).

The tax base under the reform program would be expanded by repealing most exemptions, deductions, and credits as well as a number of additional tax expenditures. These alterations would expand the tax base for all income classes. An income-based refundable credit would assist the same lower-income groups even as it provided about the same dollar amount of assistance as the federal income-security programs that it replaced. The refundable income tax credit would guarantee a proportion of poverty level income, which is based on a necessities budget and demographics. This credit would be phased out as an individual's income increased, although the credit phase-out would be limited by a low-level credit floor. Finally, a comprehensive value-added tax (VAT) is suggested as a means for raising net revenue and therefore as a sorely needed deficit-fighter. The regressive feature of a flat VAT would be offset by the indexation of personal exemptions and by the refundable income tax credit.

Income Taxation and Welfare: The FLAN Program

Tax Code Simplification

The first step in reform is to broaden the tax base and to simplify the income-tax system even while increasing its fairness to assure compliance. Most current deductions from adjusted gross income for individual exemptions would be repealed. Although the parental personal exemption for students age 19 or over and the exemptions for the taxpayer and spouse, dependents, aged, and blind are repealed under the proposed FLAN program, these exemptions would be converted into a credit (see below). The program also would repeal most existing credits, such as the residential energy credits, targeted jobs credits, and the investment tax credit. The foreign tax credit would be retained.

Eight present deductions would be repealed and others modified; among those eliminated would be charitable contributions, moving expenses, and contributions to Individual Retirement Accounts (IRAs) and Keogh plans. The deduction for medical expenses would be altered such that the allowable deduction would be in the amount of 10 percent of adjusted gross income rather than the 5 percent under present law. The itemized deductions that would be retained are deductions for business expenses. In addition, the statutory adjustments to income that would be retained are deductions for employee business expenses and alimony paid.

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The tax base would be further broadened and the tax system further simplified by the elimination of 28 tax preferences that also would increase fairness. Gone would be such tax expenditures as the expensing of research and development expenditures and the exploration and development costs for oil, gas, and other fuels. Moreover, compensation would be taxed irrespective of source or name so that workmen's compensation benefits, unemployment insurance benefits, railroad retirement benefits, social security benefits, and contributions to employer-provided insurance and profit-sharing plans would be treated as income.

Changes in Social Security

Two significant changes would be made to social security that relate to benefits and the federal income tax treatment of those benefits: (1) The social security earnings test would be repealed. (2) Some 80 percent of social security benefits would be included in total income for federal income tax purposes.

As a result of the repeal of the exclusions for a number of employer-provided fringe benefits, the social security tax base also would be expanded such that compensation would include these items for purposes of social security taxation. Although these modifications would place social security on a more solid funding basis, the proposed negative income tax would reduce the public's reliance on social security benefits.

Necessities and the Personal Exemption (Tax Credit)

The second step makes the elements of the first palatable. Every family, rich or poor, buys necessities. Exemptions for dependents under the income tax code originally were meant to cover the above contingency, namely, to provide a tax credit equal to the amount spent simply to maintain life. Ultimately there should be only one individual exemption. The household income tax exemption for dependents would be raised to a value equal, or close to, the cost of a marketbasket of necessities for those who are poor. The value of this sole exemption, a refundable tax credit, would vary only with the cost of the marketbasket and the demographics of the household. The government annually calibrates the value of a minimal household budget by defining poverty level incomes based on the current cost-of-living and on demographic characteristics. This official poverty level would be the basis for the refundable tax credit to cover necessities.[2]

[2]In the initial proposal (Canterbery 1983), the use of the BLS "lower" consumption budget or share of it, say 80 percent, for the relevant geographic region and family size was suggested.

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Four features are aimed at providing for basic necessities: (1) a defined minimum for which a zero tax-rate applies; (2) a 10 percent tax rate on all taxable income to $20,000 (single filing status) and $35,000 (joint filing status); (3) a refundable tax credit for the poor; and (4) indexation of the refundable tax credit as well as the official definition of poverty to the annual inflation rate. (The official definition of poverty income presently varies with the inflation rate.) This means that the refundable tax credit also is indexed to inflation. The zero bracket amounts would be $1,500 for taxpayers using joint filing status, $1,000 for taxpayers using either a single or a head of household filing status, and $750 for those married and filing separately.

Marginal Tax Rates: A Tri-flat Tax

The third step introduces a modified flat tax system; three statutory tax rates of 10, 25, and 30 percent would be applied to taxable income. Since most deductions and tax preferences would be eliminated, the tax rates would apply to virtually all income above the zero tax bracket. The three marginal tax rates and the complete tax schedule appear in Table 1. The maximum marginal tax rate of 30 percent would be attractive to almost everyone. In addition to modifying the rate structure, the FLAN program would abolish indexation of the tax brackets. However, the indexation of the refundable tax credit under FLAN would moderate, but not eliminate, the present-law automatic stabilization. Since this proposal attempts to insure that families can provide for absolute necessities, the indexation of the refundable tax credit is far more important than the indexation of the three tax brackets. Moreover, the automatic countercyclical effects of the federal tax system would be retained, though probably dampened during expansions.

The Negative Income Tax: An Income-based Refundable Credit

There is still a social problem with the unemployed and present unemployables who have incomes below a minimal consumption budget. Conservatives bemoan the "disincentives" of the hodgepodge of welfare services: liberals complain about the infringements upon freedom and dignity from the various "needs tests." The negative income tax, endorsed by liberals such as James Tobin and conservatives such as Milton Friedman, is an ingenious system for transferring income to the poor, and providing a minimum guaranteed income. This income should be sufficient to maintain the social minimum for necessities. A negative income tax could reduce the present burdens placed on the social security system and the payroll tax connected with future benefits.

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TABLE 1

PROPOSED TAX BRACKETS AND TAX RATES, 1985

Tax Bracket	Rate Structure
	Single Filing Status
$0 to $1,000	no tax
$1,000 to $20,000	$0 plus 10% of excess over $1,000
$20,000 to $65,000	$1,900 plus 25% of excess over $20,000
Over $65,000	$13,500 plus 30% of excess over $65,000
	Joint Filing Status
$0 to $1,500	no tax
$1,500 to $35,000	$0 plus 10% of excess over $1,500
$35,000 to $100,000	$3,350 plus 25% of excess over $35,000
Over $100,000	$19,600 plus 30% of excess over $100,000
	Married Filing Separately
$0 to $750	no tax
$750 to $17,500	$0 plus 10% of excess over $750
$17,500 to $50,000	$1,675 plus 25% of excess over $17,500
Over $50,000	$9,800 plus 30% of excess over $50,000
	Head of Household
$0 to $1,000	no tax
$1,000 to $30,000	$0 plus 10% of excess over $1,000
$30,000 to $75,000	$2,900 plus 25% of excess over $30,000
Over $75,000	$14,150 plus 30% of excess over $75,000

NOTE: Indexation of the personal refundable tax credit would be introduced under the FLAN program and would begin in 1986. Present-law indexation of the tax brackets would be repealed.

Our society is committed to the provision of absolute necessities for every person in need. However, the welfare programs are comprised of a strange assortment of "incomes in kind." The government can best reduce its direct bureaucratic involvement in such programs by moving toward a cash payment system as quickly as possible. Even before the full implementation of a negative income tax, administered solely by the Internal Revenue Service, the government could convert the food stamp program into a cash program. Then the household would have the freedom to allocate such resources to best meet its immediate needs, and the government could get out of the welfare business. Most federal income-security programs—under the broad categories of unemployment compensation, housing assistance, food and nutrition assistance, supplemental security income, AFDC, and

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low-income energy assistance—can be eliminated under the tax reform program. The president's "Budget of the United States Government, 1985," estimates that the federal expenditures for these programs will be approximately $64 billion in fiscal 1985. Though it may be prudent to phase out gradually such programs, the need for such programs fades from the social landscape once a negative income tax is a reality. None of the other tax reform proposals provide for this social welfare reform on the expenditures side.

Under FLAN, a negative income tax, comprised of a refundable credit administered on a monthly basis by the Internal Revenue Service, would replace the present federal welfare system. The negative income tax would guarantee at least 50 percent of poverty level income to an individual electing to use the single filing status, and guarantee generally over 75 percent of poverty level income to those filing jointly. For the head of household filing status, over 60 percent of poverty level income generally would be guaranteed. To the extent income assistance is an incentive, the poor would be motivated to stay within the family unit.

The initial credit amounts that replace the current personal exemptions would be based upon both the filing status and the number of dependents. The definitions of the taxpayer, spouse, and dependents would be similar to the present tax code, although no additional credit amounts would be provided to the aged or the blind. The initial credit amount for the single person and the head of a household would be $2,800. For the joint filing status, the initial credit amount would be $5,400. To these amounts, $1,500 would be added for each dependent, up to a maximum of $6,000. The estimates provided in Table 2 and just summarized reflect averages for the population as a whole. In practice, since poverty levels vary with demographic char-

TABLE 2

ESTIMATED POVERTY LEVELS AND GUARANTEED MINIMUM INCOME LEVELS, 1985

	Family Size					
	1	2	3	4	5	6
Poverty Level (PL)	5,546	7,107	8,702	11,157	13,208	14,941
Joint Filing Status		5,400	6,900	8,400	9,900	11,400
(% PL)	NA	(76)	(79)	(75)	(75)	(76)
Single or Head						
of Household	2,800	4,300	5,800	7,300	8,800	10,300
(% PL)	(50)	(61)	(67)	(65)	(67)	(69)

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acteristics, these credit amounts would be adjusted so that the same proportions of poverty-level income would be guaranteed for the different filing statuses in various geographical areas. Credit amounts would not be adjusted to reflect different ages or a variety of family structures.

The effective marginal tax rates under present welfare programs are very high. A family of four with only $8,000 in wage income, for example, would qualify for various programs under present law. This family would be qualified to receive food stamps and the earned income credit among other benefits. The effective marginal tax rate for this family would be the food stamp phase-out rate of 30 percent plus the earned income credit phase-out rate of 12.5 percent plus the federal income tax rate of 11 percent, which yields a total effective marginal tax rate of 53.5 percent.

If this family elected to receive other federal benefits such as housing assistance, supplemental security income, or low-income energy assistance, the phase-out rates for each program would be added to this 53.5 percent. Since the phase-out rates for the housing assistance programs are generally 30 percent, for supplemental security income, 50 percent, for AFDC, 100 percent, an effective marginal tax rate in excess of 100 percent is easily attainable for those receiving benefits under several programs. The eligibility requirements of the programs vary with the state and specific circumstances.

In 1981, 58.5 percent of the 11.7 million households below the poverty line received either medicaid, public housing, food stamps, or school lunch benefits, and 37.8 percent of these households received benefits from more than one of these programs. When these income-based programs are combined with the present federal tax system very high marginal federal tax rates can result—rates far in excess of the marginal tax rates of the upper middle income or even rich taxpayers. On top of this, the earnings test applied to present social security benefits reduces social security benefits by 50 cents for every dollar earned in excess of a certain threshold, which results in a 50 percent marginal tax rate. Finally, the present-law taxation of social security benefits counts income twice over certain income ranges; in such cases a $100 increase in income adds $150 to adjusted gross income, effectively increasing the marginal tax rate by 50 percent.

The marginal tax rates under the proposed negative income tax are lower. The refundable credit would be phased out at a 35 percent rate as adjusted gross income exceeded zero, but would be limited by a credit floor. Thus, if an individual's adjusted gross income increased by $1,000, the credit would be reduced by $350. The credit floor would be equal to $100 for a taxpayer and $100 for a spouse

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plus $100 times the number of dependents. Therefore, for a family of four filing a joint return, the credit floor would be $400.

The social security earnings test would be repealed, eliminating the implicit 50 percent marginal tax rate. Also, the present-law tax treatment of social security benefits would be repealed.[3] The proposed refundable credit, meanwhile, would be lowered by 64 percent of any social security benefits received. Consequently, for those social security recipients with incomes that place them in the phase-out range of the negative income tax, an increase in social security benefits of $1,000 would result in a combined increase in federal income tax liability and a credit reduction equal to $1,000. Thus, over certain ranges of income, social security benefit increases would be offset by equal refundable tax credit reductions.[4]

Effective Marginal Tax Rates: Low-Income Taxpayers

The combination of the highest statutory income tax rate with the income-based negative income tax alters the effective marginal tax rates. For the low-income taxpayer, the first positive income tax rate of 10 percent would be added to the negative income tax phase-out rate of 35 percent. An individual whose adjusted gross income places him in the phase-out range of the negative income tax would receive an effective 45 percent marginal tax rate, the highest attainable.[5] Of course, if an individual's income places him outside the phase-out range of the negative income tax, the effective marginal tax rate is the same as the statutory marginal tax rate. This 45 percent effective marginal tax rate may seem high, but it generally represents a significant reduction compared to the present tax system.

Revenue and Distributional Effects: A Simulation

A simulation model[6] allows a comparison of the existing distribution of federal income tax liabilities by income class with the post-reform distribution. The revenue shortfalls suggested by Table 3 and

[3]The double counting of income over certain income ranges would be repealed as well.

[4]The cost of administration of this program likely would be no more and possibly substantially less than the costs of administration of the current income-security programs because duplication of services would be lessened. The administrative costs currently are approximately 11 percent of the budgets of these programs according to Congressional Research Service estimates.

[5]The tax brackets are structured so that the credit floor is attained prior to the entrance into the next bracket and its associated higher tax rate.

[6]The estimation of the revenue and distributional effects of the FLAN program is based largely on simulations using the Individual Income Tax Model of the Joint Committee on Taxation. This model compares tax liability under present law to the reform proposal

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Table 4 are not indicative of the complete proposal's impact in either 1981 or 1985. For one thing, data used in the simulation model do not contain information on the repealed provisions proposed as base-broadening measures. These "off-model" items, if repealed, are estimated to increase individual federal income tax liabilities by $5.6 billion in calendar year 1985 compared with present law. (Table 3 and Table 4 do not include these off-model items. Moreover, these tables do not address expenditure changes under the program.)

Since social security taxes also would be increased by the reform proposal, the estimated distribution of the combined tax liabilities is presented in Table 4. This distribution includes the estimated federal income tax liabilities from Table 3 plus estimated social security contributions of employees and the self-employed based upon 1985 law, excluding employers' contributions.

TABLE 3

SIMULATION OF FEDERAL INCOME TAX LIABILITIES UNDER TAX REFORM

Expanded Income ($ thousands)	Present Law	FLAN Reform Program	Change	Percentage Change
0 to 10	3,848	−66,383	−69,932	−1817.3
10 to 20	29,027	17,041	−11,987	−41.3
20 to 30	43,496	39,880	−3,616	−8.3
30 to 40	38,428	35,701	−2,727	−7.1
40 to 50	25,225	25,790	564	2.2
50 to 75	26,152	27,536	1,384	5.3
75 to 100	12,076	12,298	222	1.8
100 to 200	18,978	18,545	−433	−2.3
200 +	17,558	17,401	−157	−.9
Total	214,489	127,809	−86,680	−40.4

NOTE: Estimates are subject to rounding errors and are in millions of dollars. These figures include most of the changes made under the Deficit Reduction Act of 1984 with the most significant exceptions being changes made to income averaging and the holding period for long-term capital gains and losses.

using a sample of 86,052 actual returns weighted to represent the characteristics of the total population. The simulations use 1981 levels of income and expenditures to compare the reform program to 1985 law. Thus, this analysis is "static" in the sense that no change in individuals' behavior is provided for as a result of the change in law. Although this assumption may not be realistic in some instances, it does provide a consistent basis for comparing different proposals.

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TABLE 4

SIMULATION OF FEDERAL INCOME TAX AND SOCIAL SECURITY TAX LIABILITIES UNDER TAX REFORM

Expanded Income ($ thousands)	Present Law	FLAN Reform Program	Change	Percentage Change
0 to 10	13,722	−54,302	−68,024	−495.7
10 to 20	50,510	40,048	−10,462	−20.7
20 to 30	69,504	67,301	−2,203	−3.2
30 to 40	58,353	56,512	−1,840	−3.2
40 to 50	35,436	36,271	834	2.4
50 to 75	33,962	35,452	1,489	4.4
75 to 100	14,297	14,536	239	1.7
100 to 200	20,842	20,421	−421	−2.0
200 +	18,022	17,868	−155	−.9
Total	314,649	234,106	−80,543	−25.6

NOTE: See note to Table 3.

The FLAN program is distributionally neutral[7] for the income classes above $20,000. For the income classes below $20,000, the net effect of the program would be such that their treatment would be essentially the same as under present law. Of course, the negative income tax requires federal expenditures in the form of refundable income credits, an outlay estimated to be $63.1 billion in calendar year 1985. The estimated change in federal expenditures from all the previously described changes would be $6 billion in calendar year 1985. The estimated impact on tax liabilities of the reform program for calendar year 1985, *excluding the outlay portion of the negative income tax,* is that it would increase federal income and social security tax liabilities by $7.7 billion as compared to present law. Thus, this income tax reform program also is revenue neutral (within 5 percent of the estimate of the tax liability under present law).

A Value-Added Tax Base for Revenue Enhancement

Still, the income tax alone is not the ideal form of taxation. An effectively progressive income tax (essential for equity) cannot be neutral in its impact on the long-run allocation of resources. A tri-flat progressive tax on discretionary income, in the absence of other revenue sources, would tax personal saving at a high marginal rate.

[7]A program generally is considered to be distributionally neutral if it does not change the distribution of tax liabilities by income class by more than 5 percent.

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However, a part of this impact is mitigated by other sources of investment funds. Total federal taxes paid by corporations has steadily declined from 32.1 percent of total federal government receipts in 1952 to 6.2 percent in 1983. A large share of gross business investment is financed from retained corporate earnings. These earnings come from consumer expenditures that would be bolstered by spending from tax-exempt income and the negative income tax. Nevertheless, in the interest of neutrality and the avoidance of double taxation of corporate profits, ideally a final step ought to be taken, namely, to reduce corporate profits taxes to zero. This move, however, cannot be made in a single step because of present revenue requirements and because of the tax avoidance that incorporation would provide.

The impending death of corporate income taxation and the residual problems with even a reformed personal income tax system brings us to a needed and attractive additional tax base. For a quarter of a century public interest in a value-added tax has waxed and waned in the United States but never quite disappeared. During 1979 and 1980 Senator Russell Long and Representative Al Ullman, chairmen of the two congressional tax-writing committees, courageously supported such a tax. One cannot avoid speculating how much different economic history might have been if Ullman's H. R. 5665, the Tax Restructuring Act of 1979, had been considered and passed. Possibly, VAT failed to gain widespread support because it was not considered within the context of a larger debate on tax structure and equity; FLAN eliminates this objection.

Administrative efficiency and reasonable collection costs require that all consumption should be taxed at a single, flat rate—a flat VAT. For equity, this means that VAT should not be implemented without the recommended reductions in the income taxes paid on the personal income allocated to necessities. The VAT paid in the price of necessities simply would increase the value of the income tax credit for necessities for all taxpayers and the negative income tax for lower-income filers, much as would inflation. In this way VAT would be both administratively efficient and equitable; otherwise, a VAT on necessities such as food and medicine would be regressive.

A value-added tax would raise the price level by at least the percentage of the tax and thus should be implemented in stages. Such increases could be coordinated with the proposed changes in the income tax structure. For example, careful study might conclude that a 2 percent VAT would be appropriate in the first year of the new tax. In theory, the tax base for VAT is the value added to the product at each level of production. In practice, the tax base is measured by the increase in sales price at each stage of production. Each stage in

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the chain collects the VAT on its sales, takes a credit for VAT paid on purchases to other firms, and remits the net amount to the IRS. At the end of the chain, the consumer pays the full amount of the tax in the sales price of the good or service and *with no other reform measure* would bear the full burden.

The consumption-type VAT nonetheless is recommended because it is neutral with regard to prices of consumption goods as long as the base is comprehensive and there is a single rate. The consumption variant also provides the most neutral treatment of capital assets and is the easiest to administer, in part because arbitrary depreciation allowances need not be calibrated. Since value added is the value that a business firm adds in the course of its operations to the goods and services it purchases from other firms, such value is added by handling or processing these purchases with the firm's labor force, machinery, buildings and capital goods. The initial acquisition of capital goods is treated the same way as the purchase of supplies so that the consumption-type VAT is equivalent to instantaneous depreciation of new plant and equipment. Since the firm may deduct, in the year of the purchase, the full value of the capital good, the value-added by the capital equipment is not subject to taxation until later years, as the equipment is consumed in the process of production. Thus, taxation on the "value" of capital also happens only once.

Consider the following example for the tax base under the consumption variant of VAT. During the taxable year the firm's gross receipts are $125,000. During the accounting period the firm purchases $25,000 of materials and supplies from other firms and $10,000 of machines (capital goods). The tax base would be $90,000: The purchases on both current account ($25,000 for materials and supplies) and capital account ($10,000 for the machines) are subtracted from the gross receipts from final sales.

Exemption's from the VAT base should be rare. Most experts, however, would agree to the following exemptions. Exports should be exempt in order to avoid taxing our foreign neighbors (whose own VAT is refunded on our purchases). The rental value of owner-occupied homes should also be exempt because of the administrative nightmare of calculating imputed (unobserved) values. Federal government purchases also should be excluded because the government would pay the tax (as a part of prices) and derive no net revenue from it.

Under these provisions the VAT tax base would equal approximately 60 percent of Gross National Product. If 1985 GNP turns out to be $3885 billion (latest DRI forecast), the tax base would be about $2331 billion, and one percentage point of VAT would yield an

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additional tax revenue of $23 billion. A first-stage tax of 2 percent would yield about $46 billion.

Summary and Conclusion

The proposed income tax program (FLAN) would reform the present federal income tax system by replacing the progressive tax-rate structure with a tri-flat tax system applied to a tax base significantly expanded as a result of the repeal of a number of tax expenditures. A negative income tax, which takes the form of a refundable income tax credit, guarantees a proportion of poverty-level income. This credit would be based on demographic characteristics and would be phased out as an individual's income increased. The phase-out would be limited only by a low credit floor. Most federal income-security programs would be eliminated, but the reduction in federal expenditures would be almost equally offset by the refundable income tax credit, while assisting the same lower-income groups.

Revenue simulations suggest that the FLAN program would be revenue neutral and distributionally neutral for income classes above $20,000 for calendar year 1985. The $6 billion increase in federal expenditures, which results from both the repeal of the social security earnings test and the replacement of the income-security programs with a negative income tax, would assist mostly the income classes below $20,000, without the attendent administrative and social attitudinal problems associated with the current welfare system. The value-added tax that completes the FLANVAT program would add needed revenue for education and other programs aimed at human capital improvements. This ultimately should reduce the number of poor and thereby reduce the negative income tax credits. Eventually, VAT would replace the corporate income tax.

Economists seem to like the idea of a "use" tax. Of course, it is impossible to tie every tax to a specific use. Nonetheless, a combination of VAT and a diminished dependence on the income tax means that ultimately the personal income tax could be used solely for financing national defense. The main contribution of the working class to defense and war efforts has been to supply manpower and tax revenue. A shared social burden could be achieved by financing defense with the corporate tax (until phased-out) and the tri-flat but progressive tax rate. On the other hand VAT is less visible, less felt. Those presently in tax shelters apparently "feel" that too much of their taxes go to social programs. With the allocation of VAT revenue to the income grants for the poor, education, and other social programs, the currently sheltered could be painlessly altruistic.

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Moreover, they can see each VAT increase swell their refundable income tax credit. At last, taxation would become less painful.

We need comprehensive tax reform. A piecemeal approach is destined to fail. Because of the magnitude of the new revenue required to end the deficit problem, the required tax change will have tremendous changes in allocations of resources and the degree of equity among households. Those changes are unacceptable. Every part of the elephant must be examined; otherwise, many persons and businesses will be crushed by its misstep.

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THE FLANVAT AS TAX REFORM

John B. Egger

The paper by Canterbery, Cook, and Schmitt (1985) is apparently a report on a much larger study. Like many papers with this parentage, as a stand-alone piece its reach exceeds its grasp. But lack of space is not the only reason for dissatisfaction with the authors' case for a combined flat, negative, and value-added tax (FLANVAT).

Replacing the corporate income tax with a value-added tax is a good idea. Replacing much of the current welfare system with a refundable income tax credit, the "negative income tax," sounds a lot better than it has worked. And FLANVAT's lead-off feature, broadening the base of the income tax and taxing it at three (nonzero) rates, is a conservative and not very desirable reform.

Before discussing FLANVAT, the authors' attempt to defend the existence of taxes should be addressed. I am glad they think taxes need defending. It implies that truly radical proposals are making headway. But their claim that strong bridges and education require a federal, tax-supported government deserves very short shrift. Indeed, we might "agree to share" the cost of government as we might agree to share our wallets with an armed bandit. Their discussion is important, but only as evidence of *their* attitudes about government and ethics which feature importantly in some of their arguments.

The paper's novelty is in explicitly combining its three programs. The comprehensive income tax is an old idea, and both the negative income tax and the replacement of the corporate income tax with a value-added tax (VAT) were discussed seriously in the 1960s.

The authors state that "we need comprehensive tax reform." Because we already have a semicomprehensive income tax, there is a difference between comprehensive tax reform and the adoption of a comprehensive income tax. But the authors opt for the latter by making

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a base-broadened income tax the linchpin of their proposal. This is the conservative approach shared by most other reform proposals, including the four cited in the paper. Why the authors center their plan on it is an intriguing question.

The answer: the authors like its equity properties. (Any possible role a tax might serve as an "automatic stabilizer" usually occupies a subsidiary position among the standards of a good tax nowadays.) They launch an *ad hominem* attack on dissenters from the common notions of horizontal and vertical equity by lumping them with "special interest groups who try to control tax legislation." They also avoid any mention of serious disagreement—even among those who favor progressivity—over how progressive the tax system should be, referring to the "present income tax" as having "considerable vertical equity," and to an "effectively progressive income tax" as "essential for equity."

Even the best of the comprehensive income taxes trades away considerable economic efficiency and growth for somebody's idea of "equity" by imposing multiple layers of taxation on saving. The authors properly seek to ameliorate this with their plan to replace the corporate income tax with a value-added tax. As their taxing of IRAs suggests, though, either their beliefs about equity or their fascination with base-broadening prevents them from extending the same protection to other forms of saving.

Especially to those untrained in economics, base-broadening sounds like a good idea. It is equated to "closing loopholes," "eliminating tax preferences," "reducing tax expenditures," and so forth. We should not forget, however, that a tax base should be defined according to some well-developed and carefully analyzed theory. A tax properly called a comprehensive income tax, for example, should tax all income. Yet many economists familiar with the concept's controversies hardly would feel comfortable laying down precise guidelines about what constitutes "income" in a complex economy. Partly because of these controversies about income, a system of taxation that taxes each instance of income once and only once is bound to include provisions which look, to the layman and probably even to other economists, as if some parts of income are being taxed more than once and others not at all. In other words, loopholes are not obvious and economists should not adopt the loose language of populist reformers. As a stricter definition of a tax loophole, we might try the following: A loophole is a provision of the tax code that results in a particular activity being taxed less than it would be if the theory on which the tax is based were properly applied. If this definition works for "loophole," it also works for "tax preference."

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The authors inform us that "tax preferences . . . are so pervasive that they exceed the amount of revenue generated by the income tax system," and rely on the elimination of "tax preferences" or "tax expenditures" throughout their paper. Yet we are simply to take for granted that what they identify as "preferences," such as research and development costs, are indeed special favors not supported by tax theory. Frankly, I spend a lot of my time trying to show that many of what the demagogic tax-reformers call "preferences" are efficient and fair provisions that ameliorate multiple taxation. So I can not—and I urge others not to—take at face value the authors' assertion that eliminating "28 tax preferences . . . would increase fairness." Lacking the desire, space, and ability to defend all these preferences, I can understand why the authors failed to name, much less explain, them. But they should have acknowledged that theorizing must support the labeling of a provision as a "preference." Carried away with enthusiasm for base-broadening, they almost seem not to recognize this problem.

Even if we agree to call certain provisions "preferences," evaluating their monetary value through the "tax expenditure" approach is especially questionable. Revenue expected from the elimination of each "preference" is estimated individually, and these are summed. Ignoring the effect of the elimination of one "preference" on the revenue to be expected from eliminating another is a major flaw in these calculations. And this flaw is large enough that we should reject sums of "tax expenditures," even if we accept the static numbers associated with individual tax provisions.

Some other aspects of the authors' proposed individual income tax also deserve mention. For example, why simplicity is served by replacing the current fifteen-rate system with three rates when taxpayers use tax tables anyway is beyond me. Ninety-nine rates would not be any more complex. FLANVAT also would eliminate the indexing of tax brackets, promoting inflation as a deliberate policy of government revenue raising and violating the commonly recognized goal that an income tax should tax only real income. Comparison of FLANVAT's marginal tax rates with current law and other reform proposals is arduous because of different definitions of taxable income. Nevertheless, we can note that the base is broader than under current law and its 10 percent rate kicks in at just $1,000 for a single return. (Current-law 1986 rates impose no tax up to $2,480.)

Associated with FLANVAT's reformed income tax is its proposal to employ a refundable tax credit as an efficient replacement for many welfare programs. Like today's earned income tax credit (and unlike the blind/elderly credit), those with sufficiently low incomes could

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receive a check for the net credit left after zeroing out their taxes. Students of intermediate microeconomics can show how a cash grant would probably make the recipient better off (and can not make him worse off) than, say, food stamps of equal monetary value. There may be some philosophical appeal, furthermore, to allowing recipients the freedom to choose their own expenditures.

Under FLANVAT the IRS would have to administer a monthly refundable credit. The authors, however, do not describe its administration and I frankly do not see how the IRS could do an effective job. (Is this the same IRS that handled our Philadelphia refund checks?) It is an understatement that the IRS might have problems handling monthly estimated tax returns. The authors are correct that, even though their credit's 35 percent phase-out rate combines with the 10 percent tax bracket to produce a 45 percent marginal tax rate, this would be considerably below that faced by many current recipients of government assistance. But as with any negative income tax (NIT) which tries to assure a reasonable income level while also keeping its phase-out rate low to avoid disincentives to work, FLANVAT reaches into the middle class. Under the NIT component of FLANVAT, the credit (ignoring the floor) of a joint return filed by a family of four would not be completely phased out until income reached $24,000.[1]

Adding to the plan's complexity is the indexing of these tax credits to the cost of living in the taxpayer's geographic location. Remember that the NIT would be an integral part of the tax return each of us—not just recipients of aid—files. We would have something like a refundable personal exemption indexed to where we live. How specifically is location defined? California? Los Angeles? Beverly Hills versus Watts? What if we moved a couple of times during the year? The problem is not intractable, but it is not simple either.

Those who like the sound of the NIT should take a look at the massive 1983 *Final Report of the Seattle-Denver Income Maintenance Experiment* ("SIME/DIME"). Following a closely monitored method, the Seattle and Denver researchers found that a universal NIT, which would replace the existing (1971–77) welfare system, "would lead to significant reductions in virtually every major dimension of labor supply." Furthermore, "marital dissolution rates among whites and blacks were higher and remarriage rates among Chicanos were lower as a result of the experimental NIT treatments." These and many other findings of SIME/DIME deserve careful attention. Readers who think that philosophical and/or economic principles

[1]The family's FLANVAT guaranteed income level of $8,400 is 35 percent of $24,000.

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imply otherwise should consider the following: The giver of a gift violates nobody's freedom by attaching strings, and it is his—and only indirectly the recipient's—utility that should be considered. Those to whom the simple philosophy and economics of NIT appeal to should try to find out what effects NIT actually has before making policy recommendations.

The best idea in FLANVAT is the replacement of the corporate income tax with a value-added tax. This tax reform, which was advocated during the 1960s and 1970s, would replace a complex tax that is biased against saving and investment with a more neutral tax that is comparatively simple to implement. Although the authors recognize these advantages, they do not accurately depict the VAT in their discussion.[2]

The VAT is inaccurately characterized as a tax on consumption. The authors do not mean that it is actually paid (that is, remitted to the IRS) by consumers, since they describe what others call the "invoice method" of collection and payment. They explain why they call it a consumption tax, and if they were right the name would fit: "the consumer pays the full amount of the tax in the sales price of the good or service and *with no other reform measure* would bear the full burden."

The authors are mistaken. A value-added tax is borne by those who add the value: individuals as suppliers of the factors of production. It is useful to picture a product's supply curve without taxes and after the imposition of the VAT: the new curve will lie above and to the left of the former curve. Unless the consumers' demand curve is vertical, so that they buy the same quantity at the higher (after-tax) price as before, consumers and producers will share the tax's burden. The producer will sell less and receive a lower price (after paying the tax) than before the imposition of the tax. Because producers sell fewer units, they hire fewer inputs and offer less for them so the tax is passed back to individuals in their roles as factor suppliers.

Two errors follow from the authors' mischaracterization of the value-added tax as a tax on consumption. First, the VAT is not regressive; rather it can be viewed as a proportionate tax on saving and consumption—unlike the income tax, which falls disproportionately on saving—or as a proportionate tax on factor incomes. The wealthy may proportionately save more and enjoy more interest income, but neither savings nor interest income escapes taxation.

The second erroneous inference the authors draw is that "a value-added tax would raise the price level by at least the percentage of

[2]See Ture (1972) for a detailed analysis of the VAT.

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the tax . . . ." Replacing the corporate income tax with a VAT would increase output and transactions by reducing distortions in production. The authors never explain why—and I do not think there is an explanation why—the demand for money would fall so much that velocity of circulation would increase by at least the percentage of the VAT plus the percentage change in transactions.

It is hard not to sympathize with a paper that proposes replacing the corporate income tax with a value-added tax, especially when the authors' description of the VAT's neutral treatment of capital assets is so good. However, the authors are mistaken in several of their other observations about the VAT. Moreover, it is a puzzle how the authors, who understand the virtues of the VAT, can combine it with the comprehensive income tax, which is the most conservative tax reform proposal. Finally, the third part of FLANVAT, a negative income tax, seems to promise considerably more than it delivers.

The paper suffers from a preachy tone which imputes ethical deprivation to readers who disagree with the authors' views on government and progressive taxation. As for "painless altruism," I do not think there is such a thing. If the authors mean actions that help both one's self and others, then the best thing tax reform can do is to eliminate the present code's disincentives to investment and saving. FLANVAT's second syllable is a good start.

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SOME INTERNATIONAL COMPARISONS OF SUPPLY-SIDE TAX POLICY

Alan Reynolds

Introduction

Mainstream macroeconomics leaves policymakers wandering through a circular maze of paradoxes. Budget deficits supposedly stimulate private spending, causing inflation, but they crowd-out private spending and strengthen the dollar. An increase in public and private borrowing raises interest rates and higher interest rates reduce borrowing, thus reducing interest rates and raising borrowing.

Interest rates rise if the Fed tightens, but easing increases expected inflation and raises interest rates. Being a net lender (to Poland and Latin America) was supposedly better than being a net debtor. But the Fed says it must keep interest rates up or foreigners would invest elsewhere. The dollar would therefore fall if interest rates were lower, and the reduced capital inflow would raise interest rates, raising the dollar. A falling dollar is inflationary, but a rising dollar is not deflationary. Instead, a rising dollar causes trade deficits, which weaken the dollar. There are two dollars, one foreign and one domestic; the fact that the foreign dollar was rising along with the domestic money supply proved there were too many dollars and each dollar is too valuable.

Faced with this sort of confused consensus of demand management, both fiscal and monetary, I once persuaded my neighbor, Jude Wanniski of the *Wall Street Journal*, to adopt a label coined by Herb Stein at a conference at the Homestead (26 March 1976). Stein had ridiculed Mundell's "supply-side fiscalism," but Wanniski converted that to "supply-side economics" because tax rates were only half of Mundell's program. In response to the U.S. abandonment of Bretton Woods monetary rules, Mundell (1971) had predicted worldwide inflation, and proposed reversing the conventional International

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Monetary Fund (IMF) or Brookings Institution "policy mix." Higher tax rates would not reduce inflation, he argued, but merely suffocate incentives for added effort and investment, reducing productivity and aggravating stagflation. Monetary policy should focus on stabilizing the value of national currencies in terms of gold or commodities and also in terms of each other, to restore the efficiencies of a common unit of account of predictable value. Separate tax and spending policies should concentrate on dynamic efficiency and incentives.

The task of this paper is half of the Mundell mix—to relate the economic performance of various countries to the microeconomic details of their tax structures. This is not intended to deny the importance of other policy issues such as protectionism, monetary instability, excess regulation, or insecurity of property rights.

The basic theme is that the global deterioration of tax policy in the past decade has been most significant in individual income and payroll taxes on both capital and labor. This is not usually due to higher tax rates per se, but to the falling income thresholds at which the highest rates apply. We begin with illustrations from the United States, compare tax data from industrial countries, and then extend the comparisons to developing countries. This evidence generally supports the hypothesis of Waud (1985)—that chronic worldwide budget deficits suggest many countries are now close to or beyond the downward sloping portion of the long-run Laffer curve, where lower marginal tax rates would yield more real revenue in the long run.

Supply-Side Tax Policy in the United States

The 1981 Reagan tax plan combined populist supply-side elements with the corporatist "capital formation" ideas that sometimes adopt a supply-side label. The Conable-Jones investment incentives came first, and a diluted Kemp-Roth arrived in 1983. As I wrote in 1980, however, "cutting a firm's taxes won't help much if those who would otherwise buy its products and securities are impoverished and demoralized by personal taxes. . . . Machines cannot replace managerial spirit, innovation or personal effort and ambition" (Reynolds 1980).

To focus on the corporate profits tax alone is always a mistake. All taxes are paid by people, in their capacity as suppliers of labor and capital. Not all businesses are corporations, and not all investing (including schooling) is done by business. Household property and incomes bear heavily on corporate success, because households own

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and finance the corporations, and because such taxes also affect labor costs and sales.

If asked to define a favorable tax climate for investment, most businessmen would describe the tax code of Britain, Ireland, or Denmark, not that of Japan. Britain allows a first-year write-off of most equipment, with a zero tax rate on distributed earnings and on new corporate investment (King 1983). Compared with U.S. depreciation periods of 3, 5, or 18 years, on the other hand, Japan's write-offs cover 6, 15, and 45 years, and Japan rarely grants an investment tax credit. Japan's 56 percent corporate tax rate compares with 40–45 percent in Denmark, Belgium, and the Netherlands, and with 10 percent on Irish manufacturing.

In 1982, corporate tax revenues amounted to 5.4 percent of gross domestic product (GDP) in Japan, 2.1 percent in the United States, and 1.7 percent in Sweden. One reason that Japan collects so much corporate revenue is that corporations are quite profitable. But that, in turn, may well be a result of Japan's moderate taxation of individual stockholders, bondholders, workers, and customers.

In the United States, in both 1962 and 1981, the view that corporate taxes were most important led to postponing reductions in individual tax rates for two years, while instead adopting accelerated depreciation and the investment tax credit. In both cases, nothing much happened until personal tax rates were later reduced. A recent study by Sahling and Akhtar (1984–85, p. 26) concludes that "the faster business output growth in this recovery relative to the average of previous recoveries reflects, to a large extent, the stimulative effect of *personal* tax cuts."

U.S. corporate taxes dropped from 48.4 percent to 31.3 percent of inflation-adjusted profits over the past five years. But Tatom's (1984) estimates indicate that the reduction of marginal tax rates from combined individual income and social security taxes has been quite modest indeed—down from 55 percent to 52 percent at double the median income. High marginal tax rates remain a massive obstacle to efficient production and exchange. They punish people for earning more by producing more, and thus penalize increased productivity.

By far the largest tax on capital is imposed through *individual* taxes on both income and property. Before-tax corporate profits are less than 40 percent of the income from capital taxed through individual tax schedules—individual interest income, dividends, capital gains, rent, and proprietorships. Even aside from proprietorships and capital gains, income from investments amounts to more than 22 percent of personal income less transfer payments (which are mainly tax-exempt). But that vastly understates the *marginal* impact of individ-

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ual income taxes on investment, because income from capital assets is highly concentrated in the higher tax brackets and the marginal individual rate is higher than the corporate rate in all countries. Individuals also pay most property taxes, which reduce the return on capital in general, including corporate capital.

The marginal corporate tax on new equipment is now negative, according to the first Treasury tax reform proposal, but the individual tax on those same investments averages 30 percent (Treasury I, vol. 1, Tables 6-4 and 6-5). On structures and inventories, individuals bear at least a third of a higher marginal tax, depending on dividend payouts and capital gains. Actual tax rates on assets are the total resources extracted from individual investors.

The usual calculations of the "cost of capital" often ignore the marginal tax rate on individual investors, and always assume that tax changes do not affect interest rates. After surveying several studies, and adding their own, Peek and Wilcox (1985, pp. 22–23) concluded: "[T]he evidence consistently points toward an important response of interest rates to personal income tax rates . . . and [toward] the irrelevance of the corporate tax rate."

Estrella and Fuhrer (1983) estimate that U.S. marginal tax rates on household interest income rose from 26 percent in 1966 to 35 percent in 1980. Reducing marginal tax rates on individuals thus directly lowers the cost of capital to corporations by lowering interest rates. Households are net lenders to the corporations, and the amount they lend depends on the after-tax interest they receive. By reducing the "tax premium" in the interest rate (for any given monetary policy), lower individual tax rates reduce the "hurdle rate of return" to make more investments justify their financing costs.

Corporate investment incentives, by contrast, tend to raise the interest rate that corporations are willing and able to offer, to bid for household savings. Such incentives also tend to bid-up prices of capital equipment. In 1984, U.S. producer prices rose 2.4 percent on capital equipment but only 0.9 percent on consumer goods—a reversal of the pre–1981 pattern. Higher prices and interest rates at least weaken the impact of investment incentives.

Tax reform, like economic growth, is not a zero-sum contest between capital and labor. Overtaxing either hurts the other, and the individual income tax is particularly onerous on both business and human capital. There is more to economic development than bricks and machines. People matter too—particularly in an economy of complex information services. As Lindbeck (1983, p. 286) observed:

> Higher marginal tax rates create disincentives for the intensity of

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> work, the ambition to strive for promotion, the willingness to shift from one job or geographical region to another, the desire to invest in human capital (if taxes are progressive), etc. Both households and firms may also be increasingly induced to substitute productive effort in the underground economy for work in official markets—as well as to participate increasingly in zero sum games of search for tax loopholes and profitable financial speculation. The ensuing slowdown of productivity growth in official markets is likely to result in higher inflation. . . .

This certainly has been the experience of both the United States and other industrial countries, as well as developing and less developed countries, as they increased marginal tax rates on individual income beyond the peak of the Laffer curve.

Dynamics of Tax Reform: Lessons from Industrial Countries

The habitual practice of defining "fiscal policy" in terms of nominal budget deficits implicitly assumes that the effects of higher tax rates and reduced spending are essentially the same, when they are actually the exact opposite. Reducing government purchases frees resources for private uses, but raising taxes shifts resources from the private sector to the government. Reducing transfer payments raises the incentive to produce, but raising tax rates lowers that incentive. Spending measures the *average* burden of government, but not the *marginal* burden.

Even for those who measure the success of policy by what it does for the government, it is not possible to estimate the effect on budget deficits of changes in specific tax policies without first examining their dynamic effects on the economy. As Kotlikoff put it (1982, p. 26): "Descriptions of fiscal policy in terms of its effects on marginal incentives, its pattern of net transfers, and its direct absorption of resources provides more insight than the traditional classification of 'expenditure', 'taxes' and 'deficits' [which] are each ill-defined concepts. . . ."

In a recent *Wall Street Journal* article (Reynolds 1985), I contrasted average tax rates in 14 industrial and semi-industrial countries with the growth in *real* tax revenues from 1975 to 1982. The purpose was to show that raising the percentage of gross national product (GNP) devoted to taxes does not necessarily raise real revenues over time. Governments cannot pay their bills with percentages, and 40 percent of GNP that is not produced is zero.

State and local taxes were included, because the total burden affects the economy, and excessive tax rates at one level of government

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reduce the yield at another. Deflated U.S. dollars were used, because the dollar is the unit in which most commodities are priced and debts are due. National price indexes differ considerably in scope and weights, and are sometimes biased by price controls. Still, the basic results hold up if revenues are adjusted by each country's GNP deflator. On that basis, real revenues fell 6.6 percent in Sweden, from 1975 to 1982, fell 3.2 percent in Germany, rose only 2.6 percent in France but rose 75.7 percent in Japan.

The main reason high-tax countries experienced little or no real revenue growth is that they experienced little growth of real GNP (or GDP), which roughly measures the potential tax base. The top three in taxes—Sweden, Belgium, and the Netherlands—had annual real GDP growth of 1.7 percent from 1976 to 1983, while economic growth in the United States, Portugal, and Japan averaged 4.1 percent.

Even with 1.5 percent real growth, and a constant or rising tax share, the arithmetic would appear to produce some increase in real revenues. The reason it does not do so is that skills at tax avoidance and evasion increase with experience, so that taxable income shrinks relative to GDP. A second reason is the growing percentage of GDP accounted for by government consumption, whose market value is unknown. That is, GDP growth rates in places such as Sweden are mostly an illusion. The IMF (1984, pp. 35–37) found that real government consumption in Sweden grew by 3 percent a year in 1975–82, but capital formation fell by 2 percent a year and manufacturing by 1 percent. This may add up to a rise in GDP, but it does not increase the net resources available to the tax collector. As Table 1 shows, the growth of GDP in high-tax economies is not matched by growth of investment or private consumption. And governments cannot prosper by taxing themselves.

Ulf Jacobsson (1984, p. 87) summarized research on Swedish taxation as follows:

> Stuart and Feige both reach the conclusion that Sweden is on the downward-sloping part of the Laffer Curve. Stuart in his study finds that 75 percent of the decline in Swedish growth rates in the 1970's could be explained by increased taxes. Hansson and Stuart in their 1982 study based on average tax rates conclude that while Sweden is still on the upward portion of the Laffer Curve, it is on a segment where tax increases have become sharply detrimental to output. In a 1981 study focused solely on income taxation, Jacobsson and Normann reached a similar conclusion.

Studies based on average rather than marginal tax rates, or on income taxes alone (excluding the 36 percent payroll tax and the 19 percent value-added tax), obviously understate the Laffer curve effect.

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TABLE 1

WHY GDP GROWTH IS MISLEADING

Country[a]	Annual Change, 1979–83[b] GDP	Capital Formation	Per Capita Private Consumption	Government Consumption
Sweden	1.2	−0.5	−0.5	1.5
Belgium	0.9	−5.1	0.1	0.5
Netherlands	−0.3	−3.9	−1.6	1.0
Ireland	2.2	−3.5	−2.3	3.2
Greece	0.4	−4.3	0.1	2.8
Denmark	0.9	−6.4	−0.7	2.4
W. Germany	0.5	−0.7	0.1	0.7

[a]See Table 3 for individual tax rates in each of these seven industrial countries.
[b]In percent. All figures adjusted for inflation.
SOURCE: OECD (1984b).

Despite these limitations, however, the Swedish studies point to a severe loss of economic growth and real tax revenue due to excessive tax rates.

The Laffer curve is a curve, not a point. Even if a 10 percent tax surcharge yields a 1 percent addition to revenue for a year or two, but is also "sharply detrimental to output," that scarcely demonstrates that marginal tax rates are not subject to diminishing returns. Any tax policy that merely reduced long-run potential economic growth by a half percentage point a year must, with compounding, eventually erode the real tax base enough to outweigh a higher tax rate. The tax rate cannot be continually increased to offset the shrinking tax base without the ratio of tax to GNP heading toward 100 percent.

Since Swedish tax rates are already past the point of diminishing returns, it must follow that other countries with similar tax schedules could also raise more revenue with lower marginal tax rates. That clearly includes the Netherlands, Denmark, Belgium, Italy, Ireland, Greece, and perhaps West Germany.

Table 2 shows the growth of national, state, and local government debt in the highest-taxed countries compared with the United States. While debt in the United States remained at 46 percent of GNP from 1970 to 1984, it rose from 11 percent to 63 percent in Denmark, from 31 percent to 67 percent in Sweden, and from 73 percent to 116 percent of GNP in Belgium. There are two exceptions—Japan has low taxes and chronic deficits, while France has fairly high tax rates

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TABLE 2

GOVERNMENT DEFICITS AND DEBT
(Percent of GNP)

Country	Tax/GNP 1984	Deficit/GNP 1980–84	Gov't Debt/GNP 1970	Gov't Debt/GNP 1983–84
Sweden	50.6	4.6	31	67
Denmark	47.3	6.6	11	63
Belgium	45.4	10.5	73	116
Netherlands	45.4	5.9	51	61
France[a]	45.4	2.2	29	37
Austria	42.0	2.1	19	45
Italy[a]	40.6	11.4	44	85
Ireland	40.1	11.4	NA	NA
United Kingdom[a]	38.6	3.0	86	55
Germany[a]	37.3	2.9	18	41
Finland	37.0	0.1	16	19
Canada[a]	34.8	4.0	54	58
Australia	30.0	1.5	42	25
United States[a]	29.0	2.6	46	46
Japan[a]	27.7	3.5	12	67
Spain	27.2	4.5	14	31

[a]Debt/GNP ratios are for 1984 for these countries, 1983 for others. All figures include state and local government.

SOURCES: Tanzi (1985); OECD (1984a, p. 32; 1985); Morgan Guaranty (1984).

and a small national debt. In general, however, the experience of the high-tax countries casts considerable doubt on the idea that raising tax rates slows the red ink. The opposite interpretation is more consistent with this debt history—overtaxed countries are accumulating large debts even as real revenues for servicing that debt have stopped rising due to stagnation of the private tax base.

In 1980, Don Fullerton investigated the U.S. Laffer curve for the Treasury Department; his result (summarized by Protopapadakis 1983, p. 284) was that "even with optimistic assumptions about the supply of labor, the *average* tax rate on *wages* would have to be well above 40 percent before tax cuts would pay for themselves." Fullerton somehow estimated *average* tax rates of only 9 percent on labor in 1973. But the issue is the effect of *marginal* tax rates in 1985 on the *quality* and quantity of both labor and capital, including the implicit marginal cost of losing transfer payments by producing.

The relatively rapid growth of real revenues in lower-taxed countries is certainly consistent with a medium-term Laffer curve. But taxes as a percentage of GNP or GDP are a mediocre proxy for the relevant

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marginal tax rates. Table 3 instead summarizes available details about individual tax rates in industrial countries, while Table 4 compares percentages of GDP devoted to various taxes.

The data in Tables 3 and 4 yield the following seven generalizations:

1. Tax revenues, even as a percent of GDP, are only loosely related to statutory tax rates. Individual income taxes are 10–12 percent of GDP in over half of the countries, despite substantial differences in progressivity. Japan collects only 7 percent of GDP from this source, because generous earned-income adjustments, personal exemptions, and deduction of social security taxes leave a $40,000 family of four with only $23,400 in taxable income. Japan's high tax rates, therefore, have been relatively nonbinding until the last four years—imposed on a small fraction of the incomes of a small minority. In France, the individual income tax collects only 6 percent of GDP from individual incomes, because increasing income from $59,000 to $78,000 only raises average tax rates from 19 percent to 26 percent yet it raises marginal tax rates from 35 percent to 63 percent.
2. The absolute and relative burden of the corporate profits tax has, if anything, an inverse correlation with growth of the private economy or capital formation. Sweden obtained only 3.2 percent of revenues from corporate profits over the 1975–82 period, while Japan obtained 20.8 percent, and the United States obtained 10.1 percent. Gross capital formation including government investment fell by 2 percent a year in Sweden (and even more in Belgium and the Netherlands), but rose slightly in the United States and increased by 3 percent a year in Japan. National and local corporate tax rates are highest in Japan, Germany, Canada, and the United States, and lowest in Denmark, the Netherlands, Belgium, Ireland, and Switzerland.
3. Seven countries that rely heavily on consumption taxes, amounting to 12–16 percent of GDP in 1982, experienced average inflation of 9.4 percent in 1975–82, compared with 5.2 percent inflation in the other countries (except Italy). Capital formation in consumption-tax countries was generally slower than among countries with relatively higher corporate taxes.
4. Eight of the major countries completely exempt at least some capital gains from taxation, and the average maximum rate among all of them is 20 percent. France, Austria, Germany, and Japan are particularly gentle with capital gains taxes, as is the United States since 1978.

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TABLE 3

INDIVIDUAL TAX RATES AND ECONOMIC GROWTH

Country	Maximum Individual Tax Rate[a] 1979		Maximum Individual Tax Rate[a] 1984		Annual Percentage Change Real GDP 1979–83	Annual Percentage Change Capital Formation 1973–83
Major Industrial						
Sweden[b]	87 @	38,700	80 @	39,600	1.2	−0.5
Netherlands	72 @	92,600	72 @	61,400	−0.3	−1.6
Belgium	76 @	136,400	76 @	63,000	0.9	−1.2
Italy	72 @	595,000	81 @	257,900	0.6	−0.4
Denmark	66 @	26,900	73 @	22,200	1.2	−3.3
France	60 @	92,000	65 @	31,900	1.0	0.5
Norway[b]	75 @	60,000	64 @	33,900	2.4	2.0
Germany	56 @	140,800	56 @	41,200	0.5	0.2
Luxembourg	58 @	63,400	60 @	55,000	1.3	−2.5
United Kingdom[b]	83 @	48,600	60 @	41,700	0.5	−0.3
Austria[b]	62 @	111,500	62 @	67,900	1.5	0
Canada	47–62 @	84,100	49–60 @	44,800	1.0	1.3
Finland[b]	65–71 @	64,500	64–70 @	61,600	3.3	0.9
Switzerland[b]	31–44 @	55,300	33–46 @	151,000	1.4	−0.4
United States[b]	70–75 @	60,000	50–59 @	162,400	1.0	0.5
Japan[b]	75 @	396,900	70 @	317,400	3.8	1.9

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Other Industrial						
Greece	60 @	82,200	63 @	37,900	0.4	−1.9
New Zealand	60 @	23,100	66 @	17,900	1.6	−0.6
Ireland	60 @	14,200	65 @	19,800	2.2	1.8
Spain	66 @	142,000	66 @	70,300	1.3	−1.0
Australia[b]	62 @	37,700	60 @	29,500	1.9	0.7
Turkey	NA		60 @	55,900	2.9	3.6
Cyprus	60 @	13,900	60 @	21,700	4.0	NA
Portugal[b]	84 @	20,900	69 @	41,500	4.7	0.9

[a]Tax rate (percent) and corresponding taxable income (in dollars).

[b]Indicates countries in which tax rates have been reduced, or thresholds raised, since 1975. A range of tax rates indicates varying regional taxation. Thresholds were calculated using exchange rates on 1 March 1979 and 31 December 1984, except for Portugal, which was updated to 5 June 1985.

SOURCES: Price Waterhouse (1984); IMF (1984); OECD (1984b).

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TABLE 4

TAX REVENUES AS A PERCENT OF GDP, 1982–83

Country	Total[a]	Individual	Social Security	Consumption	Corporate & Property
Major Industrial					
Sweden	51	20	21	12	2
Netherlands	47	11	19	11	5
Belgium	45	17	14	12	4
Italy	41	10	19	7	4
Denmark	46	24	1	16	3
France	45	6	19	13	4
Norway	46	12	10	17	10
Germany	37	11	13	10	4
Luxembourg	43	11	11	8	8
United Kingdom	38	11	7	7	9
Austria	41	9	13	13	2
Canada	33	12	1	12	6
Finland	35	16	3	15	3
Switzerland	32	11	10	6	4
United States	29	12	8	5	5
Japan	28	7	8	4	7
Other OECD					
Greece	33	4	10	13	3
Ireland	39	12	6	18	3
Portugal	33	7[b]	9	13	4[b]
Spain	27	5	12	6	2
Turkey	19	9[b]	1	6	4
Australia	30	14	2	10	5
New Zealand	33	20	0	8	5

[a]Totals are for 1983, and may therefore exceed the sum of the components, since the last three columns are for 1982.
[b]Estimate.
SOURCES: OECD (1984c; 1985).

5. Nearly all major countries, except the United States, permit deduction of social security taxes, as well as deduction of premiums to private life insurance and pensions. The United States imposes a double tax on labor income.
6. Countries in which combined taxes on individual incomes and payrolls exceed 25 percent of GDP—Sweden, Belgium, the Netherlands, Italy, and Germany—have all experienced economic stagnation or contraction.

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7. A few countries—Spain, Hong Kong, and Switzerland—have a maximum average tax, which reduces marginal rates as income rises. Belgium and Turkey simply reduce marginal tax rates at higher incomes.

These observations are consistent with a wide variety of interpretations, but they are not consistent with the usual businessman's view that growth can be improved by shifting tax burdens from corporations to their individual owners, workers, and consumers. Doing that raises the marginal cost of both labor and capital that households supply to corporations.

What is perhaps most striking about the comparison is that even the relatively low-tax countries are not really far from the Swedish situation, in which a strong Laffer curve effect is well-documented. In Japan real GNP growth averaged 10.3 percent from 1963 to 1973, when individual taxes were only 4 percent of GDP. Since 1977, that tax ratio rose from 5 percent to 7 percent; economic growth slowed in every year, to 3 percent in 1983. Incomes have risen so fast in Japan that previous phantom tax brackets are now affecting enough people to deter added effort and investment. Japan cut individual tax rates by 5 percent in 1984, and real output rose 5.8 percent, but that will have to be periodically repeated if Japan is to avoid a Laffer trap.

Back in 1969, Vito Tanzi of the IMF published *The Individual Income Tax and Economic Growth: An International Comparison.* His conclusion was as follows (p. 109):

> The relationship between the personal income tax and the gross national product of countries has shown that Japan, with the fastest rate of growth is also the only one where the percentage of the tax to gross national product has decreased. . . . on the other hand the United Kingdom, with the slowest rate of growth, is the one in which that percentage has increased the most. . . . For Germany, the percentage remained almost constant during the period of highest growth. . . . It is important to point out that in the absence of any governmental action, the countries [in which real GNP] increased fastest are those which should have shown the largest increase in the tax/GNP ratio. The fact that they did not . . . was the result of frequent tax cuts.

We could only add that those countries that repeatedly reduced individual tax rates also experienced, and continue to experience, the most rapid increases in real revenue from *all* taxes.

Whenever excessive marginal tax rates have been reduced, there has been a sudden upward kick to real output, even when tax rates remained too high for longer-run development. The prospect of improved after-tax income streams is discounted in equity markets,

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reducing the cost of capital and raising wealth. The recent U.S. example was not lost on foreign governments, but few have noticed how dramatic a difference there really was. In the first six quarters of the 1983–84 expansion, U.S. gross capital formation rose by 25 percent, while Japan's real capital formation fell by 1 percent (U.S. Department of Commerce 1984, pp. 14, 42).

There have been other experiments. Austrian tax rates on individuals were massively reduced in 1976. At an income of $20,000, individual income taxes fell 55 percent between 1975 and 1977 for singles and 24 percent for families. Real GDP growth was 4.5 percent in 1976–77, and growth of real tax revenues was 5.7 percent. Austria has no tax on capital gains and the social security tax has a zero marginal rate above $25,000 a year.

In 1982, Sweden passed a small cut in individual tax rates phased-in through 1984, cutting the top rate from 87 percent to 80 percent. It also exempted up to a third of income from taxation if invested in Swedish equities. From September 1982 to March 1983, the 64 percent rise in the Swedish stock market was the highest in the world, even in dollar terms. Real GNP has grown at almost a 3 percent pace in 1983–84—statistically exaggerated, but nonetheless triple Sweden's average over the previous eight years. It is ironic that defenders of high taxation often point to Austria and Sweden as examples of why tax reduction is unnecessary. The government of Sweden has promised to ease income taxes again, but is holding that promise hostage to an unrealistic combination of devaluation and wage restraint. Denmark is attempting to reduce the top tax rate from 73 percent to 68 percent, but the total package is not promising.

Finland cut individual taxes from 19–20 percent of GDP to 16 percent in 1978 and 15.1 percent in 1979. Real growth of 0.2 percent in 1976 and 1977 rose to 7.4 percent in 1979 and 5.6 percent in 1980. With one of the lowest national tax rates in Europe, Finland experienced above-average growth over the past three years and a 6 percent unemployment rate—half the European average.

Observing that high marginal tax rates merely "stifle initiative and output," President Mitterand of France removed a surcharge on higher incomes and recently cut individual tax rates by 5 percent. The United Kingdom eliminated a 15 percent surcharge on investment income in April 1984, and repealed some capital gains taxes in July 1985, but the U.K. appears to be retreating from tax relief scheduled for March 1986. Canada is moving backwards, proposing a progressive surtax for 1986.

The tax problem in Germany was obvious even to the London *Economist* (4 February 1984):

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> Personal tax allowances are not indexed-linked. Having last been adjusted in 1974, they now look distinctly ungenerous. . . . The top marginal tax rate on personal incomes, at 56%, is considered discouragingly high. The government . . . . reckons that to restore incentives on a really worthwhile scale it would have to forego revenue of around DM 20 billion.

Germany has finally announced a modest tax relief plan for the future, but even Paul Volcker regards it as too little and too late. Meanwhile, employment taxes pushed Germany over the edge of the Laffer curve. Real revenues in the third quarter of 1984 were down 2.8 percent from the fourth quarter of 1981, and industrial employment had fallen 7.2 percent.

There is no shortage of controlled experiments in this area. Supply-side tax theory would predict that economic performance in Ontario, Canada, with a top tax rate of 51 percent, would be superior to that of Quebec, with its 60 percent rate. It would predict that development in Puerto Rico, with a top tax rate of 68 percent, would fall behind that of any U.S. state. It would predict that Australia would outperform New Zealand, that Cyprus would outperform Greece, that the state of New Jersey would grow faster than New York, and so on. All of these predictions are correct.

Keith Marsden of the World Bank compared tax rates and performance among 10 pairs of countries with initially similar per capita incomes (Marsden 1983). He found that, "those with lower taxes experienced more rapid expansion of investment, productivity, employment, and government services, and had better growth rates—without discriminating against the poor." He also found that "expansion of the tax base generated increased revenues," and "with the exception of Japan, government deficits were smaller in low-tax countries than in their high-tax counterparts" (Marsden 1984).

Tax Policy in Developing Countries

Although the force of emulation is spreading supply-side policies throughout the industrial world, developing countries can only get U.S. or IMF aid by moving in the opposite direction. Western advisers attempt to cure capital flight from developing countries through perpetual devaluations. They seem to believe that all countries should export more than they import, and can do that by repeatedly devaluing their currencies against each other. The resulting runaway inflations cause capital flight and higher tax rates, and what is left of the economy goes underground—operating inefficiently on barter or illegal U.S. currency. Budget deficits naturally explode and cannot be

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financed responsibly because of both punitive tax rates and an unpredictable value of the monetary unit. A "brain drain" soon thwarts development of native talent and enterprise. Bankrupt industries become a drain on the treasury. And what does the IMF, or U.S. State Department then propose? Devalue again, and raise tax rates.

This mainstream formula—the opposite of the Mundell (1971) mix—has produced a rapid reduction in the income thresholds at which the highest tax rates begin to bite. It amounts to an export of Western "bracket creep" at a greatly accelerated pace—"bracket gallop."

Table 5 compares individual tax rates, thresholds, and economic growth in four regions. The high-tax countries are again at the top of each group. Countries that have reduced tax rates or raised thresholds are shown by an asterisk, except when falling thresholds clearly wiped-out a rate reduction. The third column introduces a "threshold-income ratio" to indicate whether high tax rates apply at incomes that are high or low relative to 1982 per capita GNP (in 1980 dollars).

Compare average growth of real GDP in the three highest-taxed countries in all four regions with the three lowest-taxed countries. The low-tax countries grew, on average, by 4.9 percent a year in the troublesome four years, 1979–83, while the high-tax economies actually shrank by 1.4 percent a year. Supply-side theory provides an explanation that is fully consistent with this evidence, while no other systematic monetarist or Keynesian explanation has been, or could be, offered.

Truly devastating taxation of poor people is relatively new in modern history, occurring since 1980 in most cases and since 1983 in a few. Before that, many "developing" countries merely stagnated under European-style tax penalties on added income. Only a few had taxed themselves into continually falling per capita income. In Jamaica, an early example, per capita real GDP fell 38 percent from 1972 to 1982.

Since 1977, the Jamaican dollar dropped from parity to 6-to-1 with the U.S. dollar. Consumer prices tripled, and Jamaicans now find themselves in a 58 percent tax bracket at an income of $2,500 a year. A third of Jamaica's professionals and managers have reportedly left the country, and there is considerable barter and underground commerce in tourist currencies.

A few years ago, the individual income tax still raised 17 percent of Jamaica's shrinking tax revenues—small reward for ruining the country. Manufacturing output fell by 6 percent in 1984, and the Jamaican government predicts a 3.8 percent drop in total output in 1985.

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TABLE 5

INDIVIDUAL TAX RATES IN DEVELOPING COUNTRIES

Region/Country	Maximum Individual Tax Rate[a] 1979		1984		Threshold-Income Ratio[b]	Real GDP 1979–83[c]
North & Central America						
Jamaica	80 @	17,400	58 @	2,500	2	−0.8
Costa Rica	50 @	40,700	50 @	2,300	2	−3.6[e]
El Salvador	60 @	100,000	48 @	12,200	18	−5.8
Puerto Rico[d]	79 @	200,000	68 @	200,000	52	−1.5[e]
Mexico	55 @	65,800	55 @	61,600	29	2.8
Nicaragua	50 @	200,000	50 @	70,200	82	4.8
Guatemala	40 @	500,000	48 @	337,000	314	0.2
Honduras	40 @	500,000	46 @	495,000	789	0.4
Panama	56 @	200,000	56 @	200,000	100	6.3
Asia-Pacific Basin						
Western Samoa	50 @	13,900	50 @	4,700	1	−3.9
Papua New Guinea	50 @	42,700	50 @	4,200	5	0.4
Fiji	53 @	10,000	50 @	17,300	9	−0.2
Pakistan	55 @	5,000	60 @	6,800	19	7.1
India	60 @	12,000	62 @	8,000	33	5.1
Philippines	70 @	68,500	60 @	25,300	33	3.2
S. Korea[d]	89 @	173,200	65 @	72,300	44	4.7
Thailand	60 @	50,000	65 @	73,500	98	5.5

TABLE 5 (cont.)

Region/Country	Maximum Individual Tax Rate[a] 1979		1984		Threshold-Income Ratio[b]	Real GDP 1979–83[c]
Malaysia[d]	60 @	34,400	45 @	121,900	71	6.6
Indonesia[d]	50 @	15,400	35 @	46,500	84	6.1
China[d]	0–30 @	50,000	0–45 @	50,000	200[e]	6.8
Hong Kong	15 @	20,700	25 @	5,100	1	7.0
Singapore[d]	55 @	185,200	40 @	338,400	62	8.6
Africa						
Zaire	60 @	6,200	60 @	1,400	8	0.9
Zambia	70 @	16,300	80 @	11,100	20	2.0
S. Africa	60 @	33,300	50 @	20,000	8	2.1
Morocco	64 @	189,900	87 @	78,400	102	2.0
Zimbabwe	45 @	25,000	63 @	23,100	26	5.5
Malawi	45 @	15,200	50 @	14,000	70	1.9
Egypt[d]	80 @	142,900	65 @	153,800	241	7.1
Botswana[d]	75 @	48,000	60 @	35,600	42	13.5
South America						
Peru	65 @	39,000	65 @	40	0	−1.3
Bolivia	48 @	11,000	30 @	47	0	−4.2
Chile	60 @	30,800	57 @	3,700	2	−0.3
Brazil	55 @	76,400	60 @	10,800	5	0.8

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Argentina	45 @	73,700	62 @	67,900	29	−1.8
Ecuador	50 @	108,900	58 @	28,900	25	1.8
Columbia[d]	56 @	26,500	49 @	57,600	42	2.0
Paraguay	0	NA	30 @	8,500	6	4.0

[a]Tax rate (in percent) and associated taxable income (in dollars). Exchange rates used: 1 March 1979 and 31 December 1984, except for Jamaica, Malaysia, Botswana, and Singapore, which are updated to 5 June 1985.
[b]Income at which the highest tax rate applies divided by per capita GNP in 1982 (1980 dollars).
[c]Annual percentage change.
[d]Countries that significantly reduced tax rates, or raised thresholds, since 1975. Omits countries (e.g., Bolivia and Philippines) in which the rate reduction was offset by falling thresholds.
[e]Estimate.
SOURCES: Price Waterhouse (1984); IMF (1984).

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Costa Rica also let its currency go into a free-fall in 1980, as did El Salvador and, more recently, Nicaragua. Consumer prices quadrupled and Costa Ricans found themselves in 50 percent tax brackets at $2,300 until 1985, when the threshold was raised to $60,500. Meanwhile, the 50 percent bracket in Nicaragua dropped with inflation from a $200,000 annual income to $333 by mid-1985. It is not merely the higher inflation that explains these differences—low-tax countries such as Hong Kong have had double-digit inflation at times. What almost destroyed Costa Rica and continues to devastate Jamaica is the increasing tax rates on low incomes.

In the Asian-Pacific area, there are more success stories. But Western Samoa and Papua New Guinea (like Costa Rica and Jamaica) let their currencies sink. Most other countries have "phantom" tax brackets, like the United States in 1965 or Japan in 1977, where top tax rates only apply to taxable incomes higher than the economies can yet produce. Unlike any other region, over half of the Asian countries have not only avoided bracket creep, but have raised tax thresholds since 1979. Malaysia is a good example; Malaysia's economy grew by 7.3 percent in 1984. There were also huge reductions in tax rates in South Korea, Indonesia, and Singapore.

India recently announced an increase in thresholds and a cut in the top tax rate to 50 percent (agriculture was always tax-exempt). The corporate tax surcharge and wealth tax were reduced, and death duties abolished. "The cuts are partly aimed at encouraging industrial investment and faster growth and at curbing the country's booming black economy," reports the *Financial Times* (18 March 1985), but the tax package "was larger than would have been allowed by the International Monetary Fund if its . . . . arrangement had not been terminated by India last year."

The Indian currency, already stronger than the deutsche mark, instantly rose on the news. The Bombay stock market experienced an unprecedented boom, and stock prices "doubled or tripled" between March and August (Weisman 1985).

Indonesia slashed marginal tax rates and trebled thresholds in 1983 to maintain a growth rate that has averaged 7.5 percent a year since 1968. Real tax revenues rose 47 percent from 1978 to 1982. Imports rose 47 percent from 1980 to 1983. The country produces some oil, but other oil producers have not fared so well (Iran, with a 90 percent tax rate, is an extreme example).

In China, the marginal rate on agriculture is zero. The state collects a fixed amount of produce and tax, under a contract extended from 5 to 15 years in 1983, and, as DeWulf (1985) reports,

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> the contractor is free to dispose of excess produce in free markets. . . . The system has infused the rural areas with a new enthusiasm and has been much better able to draw on the resourcefulness of the peasants. . . . The more efficient utilization of the rural work force has made about one-third of the agricultural workers redundant. . . . Industrial production in the rural areas and nonagricultural activities . . . have been stimulated and are currently, in fact, the fastest growing sectors in the economy.

Agricultural production rose 9 percent a year in 1981–83, and total GNP rose 13 percent in 1984. Zhang Jialing recently published a favorable book on supply-side economics in Shanghai.

Hong Kong has long been a supply-side paradigm, but the situation there has been slipping. The increased marginal tax rate of 25 percent is certainly modest, and comes with a 17 percent ceiling on average tax rates, but those higher tax rates now apply to significantly lower incomes. Revenue from higher tax rates, as always, has been disappointing, pushing Hong Kong's budget into significant deficit in 1983–84 for the first time in 38 years.

The Philippines is a sad example of how rapidly tax policy can collapse an economy under Western advice. Paul Wolfowitz (1985), assistant secretary of state, applauds "an IMF arrangement involving stringent austerity . . . a floating peso and broad new taxes." Already suffering from bracket creep, the Philippine economy was pushed over the cliff by IMF-State Department assistance. The Philippines' new "floating peso" fell 65 percent in 1984, inflation quadrupled to 50 percent, and real GNP fell by 5.5 percent—the first drop since World War II.

Such exceptions prove the rule. The tax-slashing, import-led, strong-currency boom that still dominates Asia remains the supply-side model for the rest of the world.

Most African countries are under IMF tutelage, and have therefore raised tax rates through both legislation and devaluation. Sudan is typical, with a 60 percent tax rate at $4,000 reimposed in November 1984. "Only a handful of African countries have managed to avoid the unwelcome embraces of the International Monetary Fund in the past few years," reports the *Financial Times* (15 April 1985).

Zambia and Zaire, like Jamaica and Ghana, have been severely overtaxed for a decade or more. Real GDP fell by 3.1 percent a year in Zambia from 1975 to 1979, despite rising copper prices. In April 1979, Zambia cut the top tax rate from 80 percent to 75 percent, and later to 70 percent. Real GDP rose by 4.1 percent a year in 1980–81 (far better than Zaire), and real revenues jumped 16 percent in a single year. In 1982, however, Zambia raised the top tax rate back to

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80 percent. Real GDP fell 2 percent, and recovered to only 1.7 percent in 1983. From 1974 to 1982, real tax revenues fell by 45 percent.

The 5.5 percent average growth in Zimbabwe is misleading. The economy grew by 13.2 percent a year in 1980–81, but Zimbabwe has since suffered a series of massive tax increases. Real output fell 1.3 percent in 1982, and by about 3 percent a year in 1983 and 1984. "The new strategy risks alienating . . . the growing black urban middle class that faces higher prices and taxes while coping with a government-imposed wage freeze," writes the *Washington Post* (14 September 1983). "Fiscal measures designed to produce ready cash for the regime serve to intensify the crisis rather than ameliorate it," adds the *Swiss Review of World Affairs* (October 1984).

The top tax rate in Malawi was 40 percent before 1979, but was raised to 50 percent by 1980. Real revenues quickly fell by 14 percent. Still, Malawi remains a relatively low-tax country by African standards, and real GDP rose by 6.8 percent in 1984.

Egypt both reduced tax rates and multiplied thresholds by ten under the late President Sadat. Growth of real GDP averaged 8.5 percent a year from 1975 to 1982.

The other supply-side success story in Africa is Botswana. Despite a severe drought in 1982, annual growth of real GDP in Botswana has actually averaged 14.8 percent a year since 1968. Real tax revenues rose 154 percent from 1977 to 1983, inflation is about 7 percent, and Botswana's budget surplus in 1983 was 7 percent of GDP. Tax rates have been reduced, and the thresholds remain comfortably high relative to income. The top corporate tax rate is 35 percent, with no social security tax.

The standard explanations do not work. Botswana started with an extremely low income, but so did many neighboring nations which nonetheless drove income even lower. Botswana has diamonds and casinos and many men working in South Africa, but that does not explain rapid growth in both agriculture and manufacturing—far outperforming South Africa or surrounding nations (Zimbabwe, Zaire, and Zambia). Botswana and Egypt have the lowest tax rates in Africa, and the results are the same as in Asia.

In South America, accelerating devaluation and bracket creep have been pushed to their logical conclusion. No nation in the area can escape the collapse of its trading partners, but two have done better than the others. Paraguay has no individual income tax, just a flat 26 percent payroll tax and a 30 percent corporate tax. Columbia both reduced tax rates and doubled thresholds. The rest of the continent is being taxed into oblivion.

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In Peru, before 1985, the top tax rate of 65 percent applied at an annual income of $40. Not surprising, "only one out of every three Peruvians is steadily employed in the formal (non-underground) economy" (Zevallos 1985). Brazil, Argentina, and Ecuador raised rates and lowered thresholds. None of these countries is doing well, to put it mildly.

Conclusion

Tax revenues are not the issue when poor countries are being taxed into even deeper poverty. Among 20 countries the World Bank categorizes as the poorest of the poor LDCs, the individual income tax accounts for only 7 percent of government revenue, on average. Most revenue instead comes from sales taxes and, unfortunately, tariffs. The fact that oppressive tax rates yield little revenue, so that taxes remain a modest percentage of (depressed) GNP, is not evidence that taxes do not matter. On the contrary, *it is precisely the ways in which high tax rates fail to yield revenue that often measures their devastating effect.* To avoid tax rates which would otherwise destroy everything, large-scale enterprises are forced to become small enough to be invisible. Henry Ford's economies of mass production are reversed, and shoes are made in basements rather than factories. Efficient marketing, such as advertising, becomes impossible because it would draw attention. Efficient accounting likewise could become evidence of tax evasion. Barter and foreign currencies replace sophisticated financial services. Overtaxed economies thus revert to primitive, pre-industrial practices, shrinking potential productivity.

The least-developed countries could easily substitute a 10 percent flat tax, with generous exemptions for the poor, without even a static "paper loss" of revenue. A humane gesture would be for Western nations to offer aid to make up for any revenue loss from tax reform. Since revenues would unquestionably soar, the gesture is free.

The overwhelming message from these cross-sectional case studies is that marginal tax rates on individuals are prohibitively high at increasingly modest incomes throughout at least half the world. Academic "reforms" are of no use unless they address this basic problem. Ending double taxes on capital is not helpful if it raises double taxes on labor. Reducing an average tax on "savings" is not helpful if it results in a higher marginal tax on earnings.

Internal research at the IMF is beginning to at least ask the right questions. A recent IMF paper by Gandhi (1985) concludes: "the tax systems of developing countries would look very different if efficient allocation were the sole concern. . . . The rates of taxation . . . would

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contain little or no progression." Needless to say, this is not the contingency the IMF attaches to its loans, but it often should be. Overtaxed nations are inherently bad credit risks.

In his recent study for the Brookings Institution, Richard Goode (1983, pp. 96–97) expressed the key issues for developing countries:

> High taxes may make people less willing to work, to assume managerial responsibility, to make innovations, to save and to invest. . . . The more progressive a tax the more likely it is that . . . incentives will be damaged. . . . Government use of tax revenues to subsidize or provide free goods and services that people would otherwise buy for themselves, such as food, housing and medical services, will accentuate the adverse effects on incentives. . . . Resistance may take the form of increased evasion . . . [or] diversion of activities from commercial or organized markets to other channels that are less exposed to taxation. . . . Migration and capital flight to countries with lower taxes are strong forms of resistance.

Strong forms of resistance are rapidly becoming the rule rather than the exception, and with ample justification. From our sample of industrial and less developed countries, it seems apparent that at least half of the countries in each category moved onto the downside of the Laffer curve in very recent years. Many of the others are already on an uncomfortable slope, where anemic economic growth makes real revenue growth less than it could be at lower marginal tax rates.

Do-it-yourself tax reduction may be better than none, but it is extremely inefficient. Lobbying costs can exceed a dollar for every dollar of loopholes. Executives can waste a day per week keeping track of business expenses and the company car. Government ends up hiring one tax collector for each of the few taxpayers who are still making profits or working in the visible economy.

Roger Waud (1985, pp. 1, 22) has noted that partly because of more intense tax avoidance and evasion:

> an inverse relationship between tax rates and tax revenues may exist at low levels of the tax rate. Consequently determined attempts to eliminate or reduce deficits can become self-defeating. . . . Once the economy is on the downward sloping portion of the Laffer Curve it may become trapped in deficit by a combination of political expediency, uncertainty about the shape of the curve, and a conventional wisdom which holds that increases in tax rates reduce deficits.

Ralph Nader's report on U.S. tax shelters likewise worries that "Congress could well discover that . . . tax cheating is so prevalent, that it *can't* even raise revenues to cut the deficits through the current tax system . . . without major rate reductions" (Meyer 1985, p. 57).

Whether we call it the Laffer curve or the Keynes curve, the Nader paradox, or the Waud trap, taxing ourselves into deficit is nothing new.

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In ancient Greece, Xenophon's *Economicus* advised that encouraging commerce would improve tax revenues—the Xenophon Curve. But Will Durant (1939, p. 466) describes what instead occurred (and is still occurring) in Athens:

> The politicians strained their ingenuity to discover new sources of public revenue. . . . The results of these imposts was a wholesale hiding of wealth and income. Evasion became universal, goods were seized, men were thrown into jail. But the wealth still hid itself, or melted away.

At Xenophon's banquet (*Socratic Discourses* 1910, pp. 179–80), Charmides explained tax collection costs and transfer payments to Socrates:

> When I was rich . . . I was forced to keep in fee with some of these pettifogging rascals that retain to the law, who swarm all over town like so many locusts. . . . I was obliged to bear public offices at my own charges, and to pay taxes; nor was it permitted me to go abroad to travel to avoid that expense. But now that my estate . . . is all gone . . . I sleep wonderfully sound, and stretched upon my bed as one altogether fearless of officers. . . . I have yet another advantage from my poverty; I then paid tribute to the republic; now the republic pays tribute to me; for it maintains me.

In ancient Rome, too, the Durants report (1968, p. 61):

> taxation rose to such heights that men lost incentive to work or earn, and an erosive contest began between lawyers finding devices to evade taxes and lawyers formulating laws to prevent evasion. . . . The government issued decrees binding the peasant to his field and the worker to his shop until all his debts and taxes had been paid. In this and other ways medieval serfdom began.

The road to serfdom and economic decline is still paved with oppressive taxation, and until that condition is repaired wealth will still hide or melt away.

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FEDERAL TAX REFORM: LESSONS FROM THE STATES

Richard Vedder

Introduction

Federal tax reform has been a major subject of contemporary debate. Certainly the current system is severely deficient with respect to the trinity of public finance criteria usually applied in evaluating taxes: administrative costs, economic efficiency, and equity. In this article, evidence from the historical experience of state and local governments is examined. Have states with relatively flat rate income taxes fared better economically than those with highly progressive income taxes similar to the federal tax? The answer, generally, is "yes," adding impetus to the calls for radical federal tax reform. Additional evidence is presented suggesting that "equity" is far less associated with the word "progressivity" in the eyes of the public than conventional political wisdom has it. The notion that support of a radical, flat rate tax would be suicidal politically is also questioned.

The great tax debate is taking place amidst $200 billion budget deficits, so the issue of deficit reduction inevitably has blunted much of the discussion of tax reform. Nevertheless, most of the major tax proposals have been condemned on the grounds that they are not even "revenue neutral," much less revenue enhancing (and, by implication, deficit reducing). It is probably true that the various flat rate proposals seriously underestimate the impact that marginal rate reductions have on the shift of activity from the nontaxable to the taxable sector. Several studies suggest that the elasticity of the tax base with respect to marginal rate reductions is quite high, even exceeding unity for some classes of income and taxpayers.[1]

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[1]See, for example, Gwartney and Long (1984, 1985), Vedder and Watel (1984), and Vedder (1985).

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Let me cite just one example. In the midst of the worst recession in 40 years, 1982, the top marginal tax rate was reduced from 70 to 50 percent and, lo and behold, the largest explosion of millionaires in the history of the Republic occurred. The number of Americans reporting an adjusted gross income in excess of $1 million instantly grew by almost 60 percent, and recent analysis by Vedder and Watel (1984) suggests that fully three-fourths of that growth reflected rate reductions rather than bracket creep or other factors.[2] Although the elasticity of the tax base is less in lower income brackets, the present flat tax proposals may be more "revenue enhancing" and less "revenue neutral" than their advocates suggest, meaning, of course, that enactment of a Bradley-Gephardt/Kemp-Kasten/Treasury type bill at rates currently discussed might actually assist in meeting deficit-reduction objectives.

On the other hand, there is considerable historical quantitative evidence that the major fiscal effect of increased tax revenues is increased government spending; when federal revenues rise as a percent of GNP, other things equal, the deficit does not typically fall, conventional wisdom notwithstanding. This assertion is backed by regression analysis. I regressed the federal deficit (D), expressed on a national income accounts basis as a percent of GNP, against the federal individual income tax (T), expressed as a percent of GNP. The unemployment rate (U) was introduced as a variable to control for deficit variation related to business cycle developments. The results for the years from 1948 to 1983 are as follows:

$$\begin{aligned} D &= \underset{(4.27)}{-9.191} + \underset{(2.802)}{.592\,T} + \underset{(6.553)}{.785\,U}, \\ \bar{R}^2 &= .60, \text{ D-W} = 1.54. \end{aligned}$$

These results suggest that increased income tax revenues are associated with increased deficits. One can argue about the direction of causality, special wartime factors, and the like, but the historical evidence suggests that increasing income tax revenues is not a useful weapon in reducing deficits. In my judgment, those wanting to take up tax increases to eliminate the deficit before considering tax reform are making a big mistake.

[2]The number of persons reporting adjusted gross income in excess of $1 million grew more than 40 percent in 1983, in part a lagged effect of the 1981 tax cut. All told, the number of returns filed from this income class grew by 118 percent from 1981 to 1983, nearly three times the average two-year growth in the past decade.

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Flatness of Marginal Income Tax Rates and Economic Growth

Considerable research has been done on the impact of changes in marginal federal individual income tax rates on economic activity, but a richer and comparatively neglected body of historical experience exists. Specifically, our state and local governments have a varied experience with income taxes. Some states levy taxes with highly progressive marginal rates, other states levy taxes that are moderately progressive, still others levy pure flat rate taxes, while a fourth group of states levies no income taxes at all. Table 1 summarizes the progressivity of state individual income taxes for 1963, 1973, and 1983. As the measure of "progressivity" or "flatness," I simply subtracted the lowest statutory rate from the maximum marginal rate levied; that range for flat rate states is zero.

In 1963 half the states either did not levy individual income taxes at all (a zero rate flat tax) or had flat or near-flat marginal rate schedules. The remaining half of the states had moderate to highly progressive marginal rate schedules. By 1973 the proportion of moderate to highly progressive rate states rose to nearly two-thirds, and the average range of rates increased by 50 percent over 1963, from 3.22 to 4.83 percent. Since 1973 the move to more progressivity has sharply slowed but not reversed. Even now, some 30 percent of the states still may be viewed as flat rate states (with zero being the rate in many cases), 40 percent are states with high marginal rate progressivity, and 30 percent are states with little to moderate amounts of marginal rate progressivity.

There is similar diversity in the way individual states changed the progressivity in marginal tax rates in the two decades after 1963. In

TABLE 1

MARGINAL RATE PROGRESSIVITY OF STATE INCOME TAXES, 1963–83

Tax Category	No. of States		
	1963	1973	1983
No Tax (Ultimate Flat Rate Tax)	19	10	10
Flat Rate Tax (Positive Marginal Rate)	2	5	5
Little Progressivity (Rate Range 0.1–3.0)	4	3	3
Moderate Progressivity (Rate Range 3.1–5.9)	15	14	12
High Progressivity (Rate Range 6.0 or more)	10	18	20
Average Range of Marginal Tax Rates	3.22	4.83	4.89

SOURCE: U.S. Department of Commerce.

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half the states the flatness of the rate structure stayed the same or (in six cases) decreased. In 14 other states, however, the progressivity of the rate structure increased substantially (three or more percentage points). In the remaining 11 states, progressivity increased moderately (the range of marginal rates rose less than three percentage points).

At the same time that state fiscal policy regarding the progressivity of marginal income tax rates varied considerably, the level of economic performance also diverged greatly. The most comprehensive and accepted measure of overall economic performance is the growth in real personal income per capita. In the 1963–83 period the variation in real income growth per capita among the states ranged from 20 percent to over 92 percent, averaging slightly under 52 percent.

If owners of labor and capital are responsive to the after-tax return on services they provide, then marginal income tax rates are indeed relevant to the determination of the amount of resource usage in a given geographic area and thus the level of income and output. The higher marginal rates are, the lower the after-tax return for additional labor and capital activity, and thus presumably the lower the rate of economic growth. Moreover, a tax with marginal rates ranging from, say, 1 to 7 percent should be more destructive of resource usage than, say, a 4 percent flat rate, if it is true that upper income groups have relatively higher sensitivity to changes in rates of return with respect to the provision of labor and capital services. Also, to the extent that a flat rate tax has a broader base and fewer resource-distorting tax preferences, one would expect greater efficiency and growth from such a tax than from a highly progressive tax with many such preferences.

Is there any relationship between the sharply divergent experience with regard to changes in income tax "flatness" and the similar diverse change in real per capita income observed between the states? Table 2 relates the mean growth rate of states to the changes occurring in the progressivity in the marginal rate structure of the income tax. States reducing the progressivity of their income tax grew substantially more than states that made their income tax less flat.

The pattern of Table 2 is reinforced by some individual case studies. New Hampshire and Vermont, for instance, are relatively small neighboring New England states. Vermont has long had a highly progressive income tax, whereas New Hampshire is well known for having the ultimate in flat rate income taxes, that is, no income tax at all. New Hampshire has always been slightly more prosperous than Vermont. For example, in 1929 its per capita income was about 10 percent higher than Vermont's. By 1983, however, the income

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TABLE 2

STATE INCOME TAX PROGRESSIVITY AND GROWTH, 1963–83

Change in Rate Structure	No. of States	Mean Growth Rate[a]
Rates Became Less Progressive	6	66.41
No Change in Progressivity	19	52.64
Rates Became Moderately More Progressive[b]	11	44.24
Rates Became Considerably More Progressive[c]	14	48.08

[a]Mean percentage change in real per capita income.
[b]The range in marginal income tax rates in 1983 was 3.0 (or less) percent greater than in 1963.
[c]The range in marginal income tax rates in 1983 was more than 3.0 percent greater than in 1963.
SOURCE: Tabulated from U.S. Department of Commerce data.

differential had more than doubled to over 20 percent, at a time when interstate income differentials were tending to narrow nationwide. A similar, though less dramatic, picture emerges with Oregon (progressive tax) and Washington (no tax).

Throughout the 1963–83 period New York had a highly progressive rate structure; moreover, progressivity increased over time. By contrast, neighboring Connecticut had no income tax throughout the period, and New Jersey moved from no tax to a tax with very little progressivity. In the two decades New York grew less than 33 percent, New Jersey more than 46 percent, and Connecticut by 48 percent. Finally, consider California and Florida, perhaps our two premier Sun Belt states. In the last 20 years California's highly progressive tax rate has increased. Florida, however, has been a "zero flat rate" tax state. From 1963 to 1983 California's real personal income per capita grew 37 percent, markedly less than the national average, whereas Florida's grew 67 percent, one of the highest growth rates of any state. Although there are exceptions to the rule, the evidence tends to support those who argue that increased marginal rate progressivity is associated with reduced rates of economic growth and, conversely, that reduced progressivity is associated with enhanced growth.

The Tax Rate–Growth Relationship: Additional Evidence

The evidence to this point can be sharply criticized for failing to take into account other determinants of economic growth. Excluding

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such variables imparts "omitted error bias" into the analysis. Moreover, it is difficult to evaluate the growth implications of moving from a state with a progressive income tax to a state with a flat tax of 3 percent. These problems largely can be eliminated by introducing regression analysis. Before proceeding to that analysis, however, some comments on state income taxes are appropriate.

Data Problems

No two states with an income tax have identical tax systems. The definition of the taxable base differs considerably among states, even on such a fundamental question as whether federal taxes are deductible against the state income tax base. Not only do the patterns of rates vary, but also the income level at which the top bracket applies varies enormously. Some states have adjusted the brackets over the years to account for inflation-related bracket creep, and others have not. In New York, for example, the top income tax bracket begins at $23,000, whereas in Ohio it begins at $100,000. The New York situation illustrates another point: As nominal income rises, the tax begins to resemble a modified flat tax because a majority of taxpayers face the same marginal rate. Other tax comparability problems abound. For example, some states exclude all social security earnings from the tax base, while others follow federal rules. Given the complexity of differences in state practices, it is nearly impossible to standardize all the diverse tax codes for comparative purposes. As a consequence, any simplified measure of marginal rate progressivity—such as the range of rates from low to high—may in fact not reflect the relative progressivity in rates. A 1 to 7 percent marginal rate range in state *A* might impart more progressivity than the same rate structure in state *B*, which has different income brackets and different definitions of the taxable base. Accordingly, some caution must be used in interpreting the results reported below.

There are alternative ways of measuring the flatness of a given individual income tax. The simplest one, and the one followed here, is simply to take the difference between the highest and lowest marginal rates. Some states had different marginal rates for so-called earned and unearned income. Generally, the marginal rate applicable to work-related earnings was used. A few states have a tax that is a flat percentage of the federal tax liability; the range of federal rates was used to calculate the appropriate marginal rates at the state level.

The Regression Model

In analyzing the flatness-growth relationship, it is important to hold constant at least a few other major factors that might contribute to

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growth differentials. Economic theory, as exemplified by Samuelson's (1948) factor price equalization theorem, suggests income differentials between regions should narrow over time. And although transport costs and nonpecuniary amenity considerations might prevent money income differentials from fully being eliminated, interstate differentials have narrowed in accord with the theory.[3] Thus in the last generation it would be expected that lower income Southern states would grow relatively faster than higher income Northern states for reasons unrelated to taxes. The per capita personal income of each state at the beginning of the period examined (1963) is an appropriate variable to introduce; this variable is called INCOME in the regression results.

Similarly, the soaring relative price of petroleum and other minerals in the 1970s improved "terms of trade" for mineral-exporting states, raising their relative incomes. Just as Saudi Arabia's per capita income rose dramatically in the 1970s relative to other nations, so Alaska, Wyoming, Texas, and several other states prospered from the oil and gas price inflation. Accordingly, the second independent control variable, ENERGY, was derived by figuring the average of mineral receipts as a percent of personal income for the beginning and mid-point years (1963 and 1973).

On the fiscal side, there is a considerable literature that suggests the overall level of tax burden is negatively correlated with economic growth.[4] Taxes on property and corporate income may inhibit growth, and, with regard to individual income taxes, a "revenue neutral" tax with a range of 6 to 11 percent could be expected to have a more adverse effect on economic growth than one with a range of 1 to 6 percent. The overall tax burden is therefore a relevant consideration. It was introduced as an additional independent variable, denoted TAX, and measured by total state and local generated revenues per $1,000 of personal income at the beginning of the period.

The key independent variable, called CHFLATNESS, measures the change in the flatness of each state's individual income tax between 1963 and 1983. The lowest marginal rate was subtracted from the highest marginal rate to get the range, and the 1963 range was subtracted from the 1983 range to obtain the change in tax flatness. For the dependent variable, GROWTH, the real percent growth in real

[3]The state with the highest per capita income in 1929, New York, had 4.08 times the per capita income of the lowest income state, Mississippi. In 1970 the highest income state, Connecticut, had but 1.88 times the income of the lowest income state, Mississippi. For historical data on interstate income differentials, see U.S. Department of Commerce (1975).

[4]Representative studies include Genetski and Chin (1978) and Vedder (1982).

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personal income per capita for the last 20 years for which state data are available (1963 to 1983) was used.[5]

The analysis of a shorter time period than 20 years raises problems, mainly because interstate variations in responsiveness to business cycle fluctuations become important. The longer the time horizon, the greater the likelihood the dependent variable reflects true long-term growth rather than factors associated with temporary variations in income levels in the beginning or end year. On the other hand, the longer time horizon also introduces some problems. The data, for example, may reflect economic conditions and structures that are no longer relevant. The 20-year period seemed to be a reasonable compromise that minimized the problem associated with evaluating growth over either too long or too short of a time horizon.

The results of the linear regression analysis in Table 3 are generally impressive. The model as a whole explains a large part of the wide variation in observed growth rates. The hypothesis that economic growth varies inversely with changes in the range of marginal income tax rates is confirmed, with the results statistically significant at the 5 percent level. Even controlling for initial income levels, the beginning overall tax burden, and energy endowments, the findings suggest that states that increased their marginal rate progressivity tended to have less growth than ones that did not.

TABLE 3

THE TAX RATE–GROWTH RELATIONSHIP: REGRESSION RESULTS

Term	Coefficient or Value	T-Statistic
Constant	122.7703	7.61[a]
CHFLATNESS	−0.9433	−1.98[a]
INCOME	−0.0227	−6.86[a]
TAX	−0.1170	−1.20
ENERGY	0.0016	3.188[a]
R^2	.6048	
$\overline{R}^2$	.5697	
Average GROWTH	51.9442	
F-Statistic	17.2160	

[a]Significant at the 5 percent level.

[5]Data for all the aforementioned variables were obtained in various publications of the U.S. Department of Commerce, Bureau of the Census, particularly the *Statistical Abstract of the United States* (various years) and *Governmental Finances* (various years.)

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The results also indicate that per capita income grew almost 1 percent less for each percentage point increase in the prevailing range in the income tax. Is that significant? Consider two states, both with $7,000 per capita income (in 1983 dollars) in 1963. Suppose one state had a flat rate tax of 3 percent throughout the period, while the other state moved from an income tax with little progressivity (a 1 percent range) to one with substantial progressivity (a 9 percent range) by 1983. Suppose the first state grew at the national average, 52 percent. If the second state, identical to the first except with regard to tax policy, conformed to the average suggested by the model, its growth rate (other things equal) would have been between 44 and 45 percent. The flat rate tax state would have had an income of $10,640 in 1983, while the state moving toward more progressivity would have had income per capita of only $10,115—$525 less. Put another way, the progressive tax state would have grown only 85 percent as fast after 1963 as the flat tax state. Thus a single policy decision—the flatness of individual tax rates—can have a considerable influence on variations in economic growth.

To what extent are these findings transferable to changes in taxes at the federal level? One might argue that "a tax is a tax" and human behavior is not influenced by whether the tax is initiated at the federal or state level. Opponents of flat taxes, however, might argue that these results, even if valid, would overstate the impact of similar changes nationally, since if a state *A* raises its tax progressivity, individuals or companies in state *A* can simply move to state *B;* if a nation raises its tax, however, internal resource mobility will not be available to permit tax avoidance, and international mobility is too costly. Although there is some truth to this criticism, it is overstated for two reasons. First, international mobility increasingly is not more expensive than domestic mobility. Second, in some cases, higher taxes lead to the nonoccurrence of an activity rather than simply shifting its location.

Beyond that, however, there is an argument that suggests the tax rate–growth relationship may be even stronger at the federal level. State income taxes have been deductible against the federal tax base, so the true marginal tax effect of any state tax rate is less, often considerably so, than the stated amount for those who itemize deductions at the federal level. At the state level, for example, a $20 tax on each additional $1,000 of income really means an additional tax liability of perhaps $12 for a high income taxpayer, whereas at the federal level that $20 tax typically means a full $20 in additional tax

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liability.[6] It is therefore difficult to imagine that the tax rate–growth relationship would be materially weaker at the federal level.

Turning to the other control variables in the model, the expected relationships were obtained. The variable measuring the relationship between the overall tax burden in 1963 and subsequent growth has the expected sign but is only significant at about the 12 percent level. The ENERGY and INCOME variables are highly robust statistically.

Sensitivity Analysis

Observed statistical relationships are occasionally somewhat unstable, that is, they are highly sensitive to changes in the specified model. The addition or deletion of a single variable will dramatically change the observed relationship between the key independent and dependent variables. In those instances, confidence in evaluating hypotheses is sharply reduced.

Accordingly, the model presented in Table 3 was adjusted in various ways—adding and subtracting variables, and even redefining the time horizon of the dependent variable, GROWTH, to cover only the 1973–83 period. Alaska was excluded on the ground that one could argue the Alaskan experience is a special case that may bias results in the direction initially hypothesized.[7] In all the various models, the expected negative relationship between changes in the flatness of the tax base and the growth rate was obtained, usually at a statistically significant level.

A detailed exposition of all the model variations is unnecessary here, but some illustrations of the point are worthwhile. I modified the basic model by adding an additional nonfiscal variable, namely, the proportion of the workforce in manufacturing in 1970 (using Census data), or MANUF. There is a structuralist explanation of growth differentials that says the manufacturing-intensive "rust belt" states have grown less because they have not adapted to changing patterns of demand. Looking at state development strategies, some have argued that public expenditures for human and physical capital formation—

[6]The current federal income tax law subsidizes individuals in states with relatively high state income taxes. Thus the removal of the state and local tax deduction against the federal tax base, which is desirable for general reasons relating to the trade off of lower marginal rates for a broader tax base, is also highly desirable as a means of removing incentives for growth-retarding fiscal policies at the state and local level. The Bradley-Gephardt proposal worsens things in one respect in that it removes sales tax deductibility but retains income tax deductibility, providing some incentive for states to switch from growth-neutral sales taxation to growth-inhibiting income tax levies.

[7]Alaska dropped its income tax near the end of the period as oil revenues surged. The direction of causation appears clearly to be the reverse of that hypothesized in this paper.

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infrastructure—have a growth payoff. As a proxy for state spending on infrastructure, state and local expenditures for highways and higher education per $1000 in personal income in 1963 and 1973 were obtained, and the average of those figures formed the basis of an additional variable, INFRASTRUCT. Other variables previously included were retained in the model.

The results in Table 4 show that the overall explanatory power of the regression model rose somewhat, but the critical relationship between FLATNESS and GROWTH is essentially unchanged. The TAX variable changes signs, but is not statistically significant; there is clear evidence that some multicolinearity is present. The infrastructure argument seems totally without foundation. The sign on the variable representing higher education and highway spending is the opposite of what is anticipated: relatively heavy spending on public higher education and on highways is negatively associated with the rate of growth, other things equal. Similarly, the structuralist argument is rejected, although the expected negative sign is obtained. There is no statistically significant association between the manufacturing intensity of a state and the rate of economic growth over the 1963–83 period.

In another regression analysis, confined to the 1973–83 period, only two income tax variables were included: CHFLATNESS, now defined as the change in the range of marginal tax rates over the 1973–83 period; and TOPRATE, defined as the top marginal rate prevailing on the income tax on individuals in 1973. The results

TABLE 4

TAX RATES AND ECONOMIC GROWTH: REGRESSION RESULTS

Term	Coefficient or Value	T-Statistic
Constant	141.7586	6.27[a]
CHFLATNESS	−0.8540	−1.91[a]
INCOME	−0.0278	−7.68[a]
ENERGY	0.0028	4.45[a]
TAX	0.0489	0.38
MANUF	−0.1351	−0.64
INFRASTRUCT	−0.3718	−2.89
R^2	.6665	
$\bar{R}^2$	.6286	
F-Statistic	17.5888	

[a]Statistically significant at the 5 percent level.

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are interesting:

$$\text{GROWTH} = \underset{(2.8844)}{5.2689} - \underset{(2.5807)}{1.2804}\ \text{CHFLATNESS} - \underset{(1.4170)}{0.3315}\ \text{TOPRATE},$$

$$R^2 = .13,\ \text{F Statistic} = 3.4873,$$

where the numbers in parentheses are t-values. The negative relationship between the change in the range of individual income tax rates and economic growth is statistically significant at the 1 percent level. The results also suggest that the higher the maximum marginal individual income tax rate was in 1973, the lower the growth in income in the subsequent decade, although that finding is only significant at the 10 percent level. The low R^2 suggests that these fiscal factors were only an important secondary explanation of growth variation in that decade; other factors, such as changing relative energy prices, were presumably even more important. However, the tax variables were subject to state policy manipulation, whereas other variables (for example, energy prices) are exogenous to state policymaking.

Finally, the original model in Table 3 was modified to exclude Alaska, which had the largest growth rate over the 1963–83 period and moved from being a progressive income tax state to one with no income tax. Even the most ardent supply-sider would probably admit that the tax change was a consequence of the Prudhoe Bay oil discovery and oil's price rise rather than a cause of the economic growth. Rerunning the model without Alaska does not substantially alter the critical relationship; the coefficient on CHFLATNESS remains negative and is statistically significant at the 5 percent level (t-value = 1.72). The observed negative relationship between increases in marginal income tax progressivity and economic growth therefore appears to be stable, enhancing confidence in the initial hypothesis.

Equity and the Flat Tax

Equity is a subjective concept rooted in human values. What is fair to one person may well be unfair to another. Although theorists have used the concept of utility to talk about equity in an objective fashion, our inability to measure utility with any precision prevents any verifiable scientific judgments being made about fairness. Economists and other so-called experts readily will oppose or support fiscal measures on equity grounds, yet their perceptions of equity merely reflect individual values that may or may not coincide with that of most of the population.

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Given all this, there is a limit to what can be said about the equity of any given tax proposal. Nevertheless, it is possible to show what changes have occurred in the tax burden for different income groups over time. Many people, most notably Walter Mondale in the 1984 presidential campaign, have argued that the 1981 income tax cut was "unfair" because it lowered taxes for the "rich" more than for the "poor." An examination of actual tax revenues for 1983 (based on preliminary IRS data) shows that with all of the 1981 tax cut in place for high income Americans (and with much of it in place for other taxpayers), tax payments for the rich had *risen* substantially relative to the poor (Table 5). This does not prove the 1981 tax cut was fair, since fairness is a normative concept, but it does suggest that the critics of the cut were arguing on the basis of erroneous information, ignoring the impact that reduced tax rates had on incentives to work and invest.

TABLE 5

FEDERAL INDIVIDUAL INCOME TAX PAYMENTS, 1981–83

Adjusted Gross Income ($ thousands)	Taxes Paid, 1983 ($ billions)	Change in Taxes Paid, 1981–83 (percent)
0 to 9.99	6.1	−29
10 to 19.99	31.6	−23
20 to 49.99	129.1	−12
50 to 99.99	53.9	3
100 to 499.99	38.4	11
500 to 999.99	6.7	63
1,000 or more	10.2	108

SOURCE: Internal Revenue Service.

The 1981 tax cut was a modest but real move in the direction of a flat rate tax; it reduced the difference between average and marginal tax rates, and certainly reduced them from what otherwise would have existed. The disparity between average and marginal rates dropped for anyone maintaining a constant real income at a near poverty level (one half the 1980 median income), at the 1980 median income level, or at a high income level (twice the 1980 median). This is verified in the first two columns and first three rows of Table 6, drawing on the recent research of Tatom (1984). Without the 1981 tax cut, the disparity between marginal and average rates would have increased for persons with the 1980 median income or above (column 3, Table 6). This is a by-product of inflation-related bracket creep.

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TABLE 6

CHANGING FLATNESS OF THE FEDERAL INCOME TAX, 1980–84

Real Income Class	Marginal Minus the Average Applicable Rate[a]		
	1980	1984	1984[b]
One-Half Median for 1980	11.7	8.6	11.0
1980 Median	12.1	10.7	13.2
Twice 1980 Median	20.7	17.3	22.1
One-Half Median for Year	11.7	12.0	NA
Median for Year	12.1	11.9	NA
Twice Median for Year	20.7	16.0	NA

[a]Lower values imply increased flatness in the federal income tax rate structure.
[b]With 1980 tax law.
SOURCE: Author's calculations from tables in Tatom (1984).

The last three rows of Table 6 account for the bracket creep effects of real income growth, which was 8 percent from 1980 to 1984. Persons whose relative income remained unchanged at one-half the median or at the median faced a disparity between average and marginal rates in 1984 similar to those in 1980, although for higher income Americans that disparity continued to grow.

On balance, Table 6 suggests the 1981 law was a modest move in the direction of flatness. Also, the 1981 and 1983 data suggest that the move toward flatness was also accompanied by an increase in the relative tax burden of the rich. Therefore the assumption that sharp reductions in marginal tax rates benefit upper-income Americans is likely fallacious. Such an assumption ignores the high elasticity of the tax base with respect to rate changes at the higher income levels (and the lower elasticity at lower income levels). In this regard, the experience of the early 1980s is similar to the experience with tax cuts in the 1920s and 1960s.[8]

Perhaps the best way to measure the "fairness" of a tax policy is to ask people whether they view it as fair or unfair. Between March 1972 and May 1984, the nonpartisan Advisory Commission on Intergovernmental Relations (ACIR) conducted 12 polls on attitudes toward a variety of topics in public finance. One question always asked is:

[8]See Frenze (1982) and Bartlett (1981) for an analysis of these earlier tax cuts.

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"Which do you think is the worst tax—that is, the least fair?" In five of the first six polls, conducted through May 1978, the local property tax was viewed "least fair"; in the six polls since 1979 the federal individual income tax has been viewed as least fair. The proportion viewing the income tax as least fair was 19 percent in the first poll, between 28 and 30 percent on the next five polls, and has been between 35 and 37 percent on all polls since 1979. While the proportion has stabilized, it rose significantly from the early 1970s to the present (ACIR 1984).[9] The 1984 results are presented in Table 7.

To many people, "equity" is largely vertical equity, or the treatment accorded to individuals in different economic circumstances. The previous discussion of the shifting tax burden since 1980 dealt with vertical equity concerns. According to the "ability to pay" principle of taxation, a progressive tax may be a fairer tax because it is borne disproportionately by those with higher incomes better able to pay. Yet the results shown in Table 7 do not fit that generalization about progressivity. The federal income tax, which is relatively progressive, is considered far more unfair than a tax that is clearly regressive, namely, the state sales tax. This is not to say that the public is unconcerned about the tax burden of the "rich" relative to the "poor." In another question in 1983, nearly half the respondents thought making "the upper income taxpayers pay more" was "the single most important change that would make the nation's tax system more fair."

TABLE 7

"WHICH DO YOU THINK IS THE WORST TAX—THAT IS, THE LEAST FAIR?"
MAY 1984 POLL

Tax	Percent
Federal Income	36
State Income	10
State Sales	15
Local Property Tax	29
Don't Know	10

SOURCE: ACIR (1984).

[9]There was little variation in the dislike for the income tax across age, sex, racial, geographic, and occupational groups. Americans over 65 did have a slightly greater dislike (32 percent vs. 29 percent) for the property tax; blacks considered the income tax "least fair" slightly more than whites (36 percent vs. 35 percent). Dislike of the income tax was highest in the West (44 percent liked it least) and lowest in the Northeast (27 percent considered it "least fair").

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Is it inconsistent to show relative preference for regressive-type taxes (for example, sales taxes) on the one hand and call for more taxation of the rich on the other? Not necessarily. One possibility is that the public is more concerned about horizontal equity—the tax treatment of individuals in similar economic circumstances. It may well be that the public is furious that some rich people pay almost no income taxes, hence explaining the call for more taxation of the rich. At the same time, the public may not want a tax that "soaks the rich," hence the preference for relatively regressive taxes. In other questions this preference for regressive taxes is confirmed. In 1983 respondents indicated a more than 2 to 1 preference for a national sales tax over higher income taxes; the same ratio applied with respect to new state and local taxes. People even preferred higher property taxes to higher income taxes.

On another, even more revealing question asked in 1984, respondents showed a preference for raising more federal revenue by expanding the tax base and reducing special treatment for capital gains (47 percent) over raising individual income tax *rates* (7 percent); the other option well received (32 percent) was a national sales tax (ACIR 1984). The public seems to want to widen the tax base and is averse to high tax rates. In short, people seem to want a tax similar to the current proposals for a flat rate tax and a modified flat rate tax.

Two other pieces of evidence suggest that a move toward a flat rate tax would be perceived as a move toward greater equity, even if the flat tax involved less progressivity on average than is presently the case. According to Vedder and Frenze (1983), the rise in dissatisfaction with the federal income tax came at a time when the tax itself strayed further and further from the flat tax ideal (see Table 8).

Table 8 includes a "flatness index," which is one divided by the ratio of marginal to average tax rates applicable for a given income level. If marginal and average rates are equal (a pure flat rate tax with zero deductions), then the index number is 1.00. If there were wide marginal rate variations and substantial deductions, the ratio will tend to be much smaller. The table shows that (1) tax progressivity rose sharply in the 1970s, in accord with "ability to pay" notions of equity; (2) the flatness index fell, particularly for middle income Americans; and (3) the federal income tax was perceived to be increasingly unfair. The more the income tax deviated from the flat tax ideal, the more unfair it was perceived to be.

One final piece of evidence is also consistent with the notion that flat taxes are considered fairer. The 1984 ACIR poll indicates the portion of the respondents who consider state income taxes the least fair, categorized by four broad census regions. The two regions with

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TABLE 8

U.S. TAX EQUITY, PROGRESSIVITY, AND FLATNESS

Indicator	1970	1980
Progressivity Index I[a]	4.02	8.43
Progressivity Index II[b]	2.04	2.76
Flatness Index I[c]	.585	.472
Flatness Index II[d]	.559	.549
Percent Saying Federal Income Tax Is Least Fair Tax	19	36

[a]Average tax rate at $75,000 income in 1980 dollars divided by the average tax rate at $10,000 income in 1980 dollars.
[b]Average tax rate at $75,000 income in 1980 dollars divided by the average tax rate at $20,000 income in 1980 dollars.
[c]At $20,000 income in 1980 dollars; see text for method of calculation.
[d]At $50,000 income in 1980 dollars; see text for method of calculation.
SOURCES: U.S. Department of Commerce, Internal Revenue Service, Advisory Commission on Intergovernmental Relations.

the greatest dissatisfaction with state income taxes, the Northeast and the West, also had the two highest weighted (by population) mean range in marginal tax rates from low to high, while the two regions showing the least dissatisfaction with state taxes—the North Central states and the South—had the lowest weighted mean range in marginal rates (ACIR 1984, p. 19).[10] The correlation between weighted mean rate range and the proportion viewing the state income tax as the least fair was 0.39.

Equity, Efficiency, and Politics: Opportunities for Political Entrepreneurship

The evidence shows that economic growth is positively associated with the flatness of the income tax and also with the public's notion of fair play and equity. Yet there are powerful special interests opposed to the move toward a flat tax. What role does the above evidence suggest for the political entrepreneur?

Public choice theory shows how the concentrated benefits and dispersed costs of most tax preferences result in more extensive

[10]A strong preference for broadening the tax base, as opposed to increasing tax rates, prevailed in all income, racial, age, sexual, geographic, and occupational categories, with few differences among them. With respect to the regional groupings, caution should be used in interpreting the finding, given the small sample size used for the groups.

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lobbying on the part of the special interests than the general public.[11] Most people remain "rationally ignorant" of the details of tax legislation because the possible benefits are usually small in relation to the costs of learning and acting on the details. Not so for special interest groups that stand to gain from tax preferences. The proposed flat tax bills, however, are not comparatively minor acts of tax fine-tuning. Instead, they constitute major changes that have the potential for conferring such large benefits on individuals that a threshold may be crossed where the expected future benefits from knowledge and political action with respect to flat rate tax reform will exceed the costs of information and action. The public, therefore, may become sufficiently aroused to battle the special interests and win meaningful reform.

Enter the political entrepreneur. There would seem to be many political gains to be obtained from pushing for a flat rate tax. The tax itself is inherently popular, promises to foster economic growth, and is something that seems feasible politically.

At the level of the political party, the Democrats have lost four of the last five presidential elections, lost control of the Senate for six years, and, when Southern Democratic "boll weevils" allied with President Reagan are taken into account, have only a precarious hold on the House of Representatives. Their image is a party of special interests and old ideas, personified by Walter Mondale. The flat tax issue could help revitalize the party as a serious force in American politics. Invoking concerns about America's future, economic growth, and the injustices caused by vertical inequities, the Democrats could launch a "new idea," dilute the "special interest" labeling, and remain true to the philosophic concern over injustice and unfairness. The first Democratic political entrepreneurs to fight the Old Guard on these issues are likely to win national recognition and a place in the party's future.

As for the Republicans, the political potential for exploiting the flat tax issues is at least as great. Aggressive exploitation of the issue by President Reagan could have the impact of making the GOP a majority party for the first time since Herbert Hoover. The flat tax issue is a chance for the Republicans to recast themselves in a conservative populist image, and to dispense of their image as a party dominated by plutocratic businessmen unconcerned about fairness and the poor.

[11]See, for example, Buchanan and Tullock (1962), Buchanan (1968), and Buchanan, Tollison, and Tullock (1980).

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The economic arguments for a true flat tax are compelling, and the public would support such a tax. With good packaging and communications, political entrepreneurs could achieve electoral victories by urging sound tax reform. Nevertheless, Congress and the Reagan administration are so far dodging real tax reform; hence the public has not taken much interest in the ongoing tax debate. Legislation proposed by the Treasury has failed to take advantage of the public's underlying preference for a flat tax. The Treasury's "modified" flat tax simply opens the door for special interest pleading that is more likely to succeed than if all deductions and tax preferences were eliminated. The tax bills receiving attention in Congress are even less likely to capture the imagination and active support of the public. Consequently, while the case for a true flat tax is strong, it is not clear that the tax debate of 1985 will lead to a simpler, fairer, and more efficient tax system that would promote the general welfare.

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NEW EVIDENCE FOR FLAT TAX REFORM

Randall G. Holcombe

The Wrong Side of the Laffer Curve

The paper by Alan Reynolds (1985) is primarily concerned with the effects of high marginal tax rates on economic activity in various countries rather than with the flat tax proposals in the United States. His basic theme is that the deterioration of tax policy over the past decade has been most significant with respect to individual tax rates on both capital and labor earnings, and that it is not that rates have risen, but that the highest rates now apply to much lower income levels. Reynolds examines data from 42 countries to illustrate his case and argues that most countries are close to or beyond the downward sloping portion of the Laffer curve.

Reynolds presents a large array of interesting evidence and undoubtedly the reader who sympathizes with his thesis will find this evidence reassuring. However, it is not clear that this evidence would convince a skeptic. Reynolds makes a number of insightful observations, including the observation that if asked to describe a favorable tax code for investment, many businessmen would probably describe something closer to the tax code of Sweden or Britain rather than a tax code such as Japan's. Britain does not tax distributed earnings or new corporate investment and allows an immediate write-off of most equipment. In comparison, Japan has depreciation periods of from 6 to 45 years and a 56 percent tax rate.

Reynolds notes that in 1982 corporate tax revenues were 5.4 percent of GDP in Japan, 2.1 percent in the United States, and 1.7 percent in Sweden. His explanation is that in Japan corporations are very profitable, a result of low taxation of individual stockholders, bondholders, workers, and customers. This suggests that it is the

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marginal personal income tax rate that influences productivity rather than the corporate rate. Looking at all of his evidence Reynolds decides, as his title suggests, that the world is on the wrong side of the Laffer curve.

This conclusion raises a significant question: why would a country enact tax rates so high that it is placed on the downward sloping part of the Laffer curve? The answer and some implications will be discussed after some comments on Richard Vedder's paper.

Equity, Efficiency, and Exuberance

Vedder (1985) examines the state income tax structures in the United States and turns up some interesting evidence, namely, more progressive tax structures reduce economic growth. The key variable in his analysis is the change in the flatness of the state's tax rate over time. There are some problems with the empirical work in the paper, and he readily acknowledges this. Indeed, for this type of study data is hard to come by. The big question in his paper, though, is why he predicts a state's growth using the change in the flatness of the income tax structure rather than the progressivity itself. If the highest marginal tax rate in a state is reduced from 10 percent to 7 percent should that state have a higher rate of growth than a state that always had a 5 percent rate? Perhaps the state will have a spurt of growth after reducing the progressivity, but it is not clear that the empirical work captures everything that is going on here. What would the results look like, for example, if he had used the average marginal tax rate instead of "change in flatness" as an explanatory variable? Even though more empirical work needs to be done to reveal everything that Vedder's data set has to say about progressivity and economic growth, his results are still interesting and suggestive.

Some of Vedder's analysis is based on the factor price equalization theorem. The idea that factors of production seek employment so as to equalize the after-tax returns in various locations has important implications for tax policy, and will be explored below.

The equity issues surrounding the flat tax are of interest to Vedder; he finds that people generally view the progressive income tax to be unfair. Equity is a normative concept, but Vedder sees an opportunity for political entrepreneurship here since he views the progressive income tax as both inequitable and inefficient. It is also possible that people misperceive the positive effects of progressive taxation; this notion will be examined further along with the political entrepreneurship issue.

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The Downward Sloping Part of the Laffer Curve

An important issue if Reynolds's thesis is to be accepted is how a country could enact tax rates high enough to put them on the downward sloping part of the Laffer curve. The answer lies in the differences in the short-run and long-run responses to a change in the tax structure.[1] The supply-side response to a tax change will be more elastic the longer the period of adjustment. In the short run, therefore, it will be difficult for people to avoid paying the new tax and tax revenues will rise. However, in the long run people will move to lower-tax (or nontaxable) activities and tax revenues will fall. Therefore, even with high tax rates on the downward sloping part of the long-run Laffer curve, an increase in tax rates still could increase tax revenue in the short run. Politicians are short sighted, so there will always be the temptation to raise tax rates for short-run revenue enhancement even when this means a long-run decline in revenues.

The full benefits of a tax cut will take some time to show up as an increase in revenues even if a country is on the wrong side of the Laffer curve. People cannot adjust instantaneously to a tax cut, which means that even though there is some evidence of a supply-side response to Reagan's tax cuts, the real evidence may not come until individuals can make their longer-run adjustments to the lower marginal tax rates.

Progressive Taxes and Redistribution

Although Vedder gives evidence that people view the progressive income tax as unfair, the main justification cited by supporters for the use of a progressive tax is that it is an equitable way to redistribute income. The issue, however, deserves careful examination because redistribution through progressive taxation may not work the way people think.

Workers are interested in their after-tax compensation, not their pre-tax compensation, so if workers are mobile across jobs they will have to be compensated for changes in the tax structure. An increase in progressivity will cause people to shift out of higher paying jobs into lower paying jobs at the margin, which will require employers to raise the wages of high income people and to lower the wages of low income individuals, thereby maintaining the structure of after-tax wages following a change in the progressivity of taxes. In this way adjustments in wages will at least partially offset the redistri-

[1]Buchanan and Lee (1982a, 1982b) have explained this idea in detail; only a brief review is presented here.

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butive efforts of progressive taxation.[2] As Friedman (1976, p. 24) points out:

> . . . if all differences in income were equalizing . . . an income tax would have no redistributive effects at all, no matter how steeply graduated. The reason is that people would leave occupations especially affected by the steeply graduated tax (occupations that are highly paid to compensate for extreme nonpecuniary disadvantages, or that offer highly variable returns, etc.) and enter those less affected by it, until this pattern of relative wage rates was attained. The same relative wage rates after tax would, of course, mean higher wage rates before tax in the occupations affected by the steeply graduated tax, and this would curtail the quantity demanded to match the reduced quantity supplied.

Some evidence that this is the case is provided by Reynolds and Smolensky (1977) who compare income distributions before government taxes and expenditures (pre-fisc) with distributions after taxes and expenditures (post-fisc). They note that despite an increasing progressivity of taxes since 1950, the post-fisc distribution of income has remained approximately the same in the United States, but that there has been greater inequality in the pre-fisc distribution. It appears that market adjustments have tended to offset attempts to redistribute income through progressive taxation. One reason that high wage earners earn such high wages is to compensate them for the high taxes they have to pay.

There are two important lessons from this analysis. First, progressive taxation is probably less able to redistribute income than is commonly thought, and second, if this fact were generally known there would be greater public support for the flat tax. Additional evidence favoring the flat tax on distributional grounds is presented by Hall and Rabushka (1985). They argue that their flat tax proposal would produce approximately the same distribution of the tax burden as under present tax law.

Political Entrepreneurship and the Flat Tax

Both Vedder and Reynolds argue that the current progressive income tax is inefficient compared to a flat tax. There is a good deal of popular sentiment on their side, as attested to by the many tax reform proposals urging a flatter tax. The opportunity to establish a flat tax is certainly greater today than any time in recent history, and the challenge for its supporters is to make it politically feasible. The key to implementing any political change with wide political support is, in

[2]See Holcombe (1985, chap. 5) for a discussion of this point.

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the jargon of economists, to make it a Pareto superior move. In other words, the flat tax must be presented as a proposal that would benefit most people but would cause significant harm to almost nobody. If a tax reform is truly efficient, it must be possible to redistribute the gains from efficiency so that no one is made worse off. When this happens, everyone, once they understand the proposal, will have to be in favor.

In the real world, of course, some people would be harmed under the introduction of a flat tax, but properly packaged, the tax appears to benefit the vast majority of taxpayers. A flat tax would benefit almost every individual because of the efficiency gains inherent in it, and any political entrepreneur who tries to sell the idea must sell it on this basis. Otherwise, it will be too easy for special interests to erode a flat tax proposal by altering one item at a time until any proposal for tax reform looks almost like the current tax code. Congress, therefore, must be convinced that voters as a group would favor wiping the slate clean and starting over with a tax code that does not cater to special interests. Regretably, efficient tax reform cannot occur one step at a time—the political process grants benefits to special interest groups on a piecemeal basis but does not provide a mechanism for removing them.

All of the current flat tax proposals favor a modified flat tax with some progressivity rather than a true flat rate tax. A completely flat rate tax, however, is far superior to a mildly progressive one. Once progressivity is built into the "flat tax" it is far too easy to introduce additional progressivity, so that the tax structure eventually reverts to its prereform condition. A single marginal tax rate provides a kind of contract that can help prevent the return of creeping progressivity into the tax structure.

The undue influence of special interests means there always will be a tendency for piecemeal tax reform to erode the tax base by providing tax preferences. A slight increase in progressivity can then make up for the lost revenue. A tax structure with no special interest preferences and a single marginal tax rate can guard against such an occurrence to some degree by eliminating tax preferences along with progressivity.

Political reality is important, to be sure, but the principles behind the flat tax movement will in the long run be more important. Despite the current proposals, which retain various tax preferences and progressivity, a truly flat tax system is within the realm of possibility. If in the late 1970s someone had said that the next president would enact a tax package that would cut tax rates 25 percent over three years, drop the top marginal rate from 70 percent to 50 percent, and

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index tax brackets, most people would have scoffed at the idea. Yet it happened. Some people might view the possibility of a true flat tax as farfetched, but it is certainly not impossible. Indeed, the studies by Reynolds and Vedder are laying the foundation for a change in that direction.

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IMPACT OF FEDERAL TAX REFORM ON STATE-LOCAL FINANCES

Thomas R. Dye

State and local governments are vital components of the nation's revenue system. The state and local government sector constitutes a significant share of the GNP—10.5 percent in 1982—and about one-third of all government spending. While state and local governments have only modest responsibilities for the nation's major entitlement programs and national defense, they have the major responsibility for what many Americans consider the most vital functions of government—schools, roads, water and sewers, garbage collection, police, and fire protection. It is self-evident that any major reform of the federal tax system should consider the consequences for state and local government finance.

The specific reform proposals that impinge most directly on state and local government are the elimination of deductions for state and local taxes from the federal personal income tax base, and restrictions on tax exempt state and local government bonds.

The Elimination of Deductions for State and Local Taxes

About 35 percent of the nation's federal individual income taxpayers itemize deductions. Almost all of these "itemizers" claim deductions for state and local taxes (see Table 1). These deductions amounted to $88 billion in 1982, and were the largest of the personal deductions (aside from the personal exemption). In 1982, deductions for state and local taxes exceeded deductions for medical and dental expenses ($22 billion), home mortgage interest ($79 billion), other interest ($43 billion), charitable contributions ($34 billion), and miscellaneous deductions ($19 billion). If state-local tax deductibility were eliminated at present tax rates, the U.S. Treasury would collect an esti-

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TABLE 1

STATE-LOCAL TAX DEDUCTIONS FROM FEDERAL INDIVIDUAL INCOME TAX, 1982

Type of Tax	No. Claiming Deduction (thousands)	Percent of Total Returns	Amount of Deduction ($ billions)
Income	27,260	28.6	43,952
Real Estate	27,994	29.4	27,471
General Sales	31,968	33.6	11,428
Auto Sales	8,419	8.8	2,793
Personal Property	8,560	9.0	1,205
Other	6,823	7.2	1,187
Total	33,080	34.7	88,037

SOURCE: U.S. Department of Treasury (1984a).

mated $30 billion. Persons careless with the English language might refer to these hypothetical revenues as "tax expenditures," or even as "tax subsidies" to state and local government taxpayers.

The effect of the state-local tax deductibility is to lighten the burden of state and local government financing. The burden of these deducted taxes is reduced by the marginal value of the tax against which it is deducted. Consider, for example, a state income tax of 10 percent levied on an individual's income at the highest federal rate of 50 percent. The federal deduction reduces the marginal state tax rate to 5 percent (see Table 2).

The Regressivity of Deductibility: Marginal Rates

Federal deductibility converts a proportional state income tax into a regressive tax. For example, married taxpayers at the lowest federal marginal rate of 11 percent—taxpayers whose taxable income is $3,400 to $5,500—pay 1.78 percent of a proportional state tax of 2 percent. (Indeed, they pay the full 2 percent, if like most federal taxpayers at this lowest rate they do not itemize deductions.) In contrast, married taxpayers at the highest federal marginal rate of 50 percent—taxpayers whose taxable income is $162,400 and over—pay only 1 percent of a proportional state tax of 2 percent (see Table 2).

It is true, of course, that most states have progressive state income taxes. But there are exceptions. Indeed, state income taxes in Illinois, Indiana, Massachusetts, Michigan, and Pennsylvania are proportional. In these states, federal deductibility renders these proportional income taxes highly regressive. In other states, income taxes

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TABLE 2

MARGINAL BURDEN OF STATE INCOME TAXES UNDER FEDERAL TAX DEDUCTIBILITY

Marginal Federal Tax Rate	Marginal State Tax Rate				
	2	3	5	7	10
11	1.78	2.67	4.45	6.23	8.90
20	1.60	2.40	4.00	5.60	8.00
30	1.40	2.10	3.50	4.90	7.00
40	1.20	1.80	3.00	4.20	6.00
50	1.00	1.50	2.50	3.50	5.00

are not steeply progressive, and the effect of federal deductibility is to reduce or eliminate the progressivity of these state income taxes.

The regressivity of deductibility is aggravated by the distribution of itemizers. Only 2.7 percent of taxpayers with less than $5,000 in adjusted gross income claim the state-local tax deduction (see Table 3). This percentage rises steadily with income. All of the nation's 8,000 taxpayers with $1 million or more in annual income claim their state-local tax deduction. The average deduction claimed by the small proportion of taxpayers under $5000 who use the deduction is $716. The average deduction claimed by taxpayers with $1 million or more is $155,500. Again the regressivity of the deduction is obvious. However, political support for the continuation of the deduction may extend from the highest brackets well down into the middle class. (Note that over half of all taxpayers with $25,000 or more in adjusted gross income currently use the deduction.)

Interstate Differences in State-Local Tax Burdens

Federal deductibility also narrows interstate differences in net tax burdens, particularly at higher income levels. By decreasing the net price of government goods and services, itemizing taxpayers in high-spending, high-taxing states and communities benefit more from deductibility than those in low-spending, low-taxing states. Deductibility may reduce the incentive for high-income persons to emigrate from high-tax states.

In 1982, the average tax saving per itemized return was $770. But tax savings were $1,292 in New York compared to $257 in Wyoming (Table 4). Elimination of deductibility would cost the average itemizing taxpayer in New York, New Jersey, Massachusetts, and Washington, D.C. over $1,000.

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TABLE 3

FEDERAL INDIVIDUAL INCOME TAX RETURNS CLAIMING STATE-LOCAL TAX DEDUCTIONS, 1982

Adjusted Gross Income[a]	Total Number of Returns[b]	Percent Claiming Deduction	Amount of Deductions[c]	Average Deduction per Return Claiming Deduction[d]
Under 5	17,952	2.7	359	716
5–10	17,040	9.4	1,485	922
10–15	14,307	18.9	3,202	1,182
15–20	10,535	30.4	4,653	1,452
20–25	8,803	47.9	7,284	1,726
25–30	7,622	61.6	9,712	2,067
30–40	9,863	77.6	19,759	2,580
40–50	4,717	89.3	13,662	3,241
50–75	3,057	93.8	12,859	4,482
75–100	702	96.2	4,596	6,808
100–200	571	91.2	5,520	9,945
200–500	140	98.5	2,774	20,101
500–1,000	21	95.1	926	46,300
1,000+	8	100.0	1,244	155,500
Total	95,337	34.7	88,037	2,661

[a]In thousands of dollars.
[b]In thousands.
[c]In Millions of dollars.
[d]In dollars.
SOURCE: U.S. Department of Treasury (1984a).

However, in no state do a majority of taxpayers itemize their deductions. This means that taxpaying majorities in every state would not suffer at all from the elimination of deductibility. Nonetheless, the higher-paying citizens who do itemize probably exert disproportional political influence—voting more often, contacting their representatives more frequently, and contributing more money to political campaigns.

If deductibility is viewed as a federal tax subsidy to state and local governments, then it is distributed unevenly, with high-tax states receiving bigger subsidies than low-tax states. This implies that state-local tax burdens in high-tax states are being shifted, via deductibility, to all U.S. taxpayers. Thrifty Wyomians are helping to pay for public extravagance in New York.

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TABLE 4

FEDERAL TAX SAVINGS FOR DEDUCTIBILITY PER ITEMIZED RETURN, BY STATE, 1982

	Tax Dollars Saved per Itemized Return	Rank by Savings per Return
Fifteen States with Largest Saving		
California	971	5
Connecticut	853	13
Delaware	912	9
Washington, DC	1,116	2
Hawaii	762	15
Maine	950	6
Maryland	933	7
Massachusetts	1,018	3
Michigan	908	10
Minnesota	872	11
New Jersey	1,012	4
New York	1,292	1
Rhode Island	856	12
Virginia	801	14
Wisconsin	914	8
Fifteen States with Smallest Saving		
Alabama	442	40
Alaska	296	49
Arizona	473	37
Florida	438	41
Indiana	452	39
Louisiana	334	47
Montana	461	38
Nevada	349	46
New Mexico	322	48
North Dakota	423	42
South Dakota	289	50
Tennessee	399	45
Texas	404	44
Washington	422	43
Wyoming	257	51
All States	770	

SOURCE: Advisory Commission on Intergovernmental Relations (ACIR 1984).

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The elimination of deductibility should place downward pressure on state and local government taxing and spending, especially in the high-tax states. It is difficult to estimate exactly how much reduction in state and local taxes might be expected from this reform, because we do not know exactly how to estimate the political influence of minority itemizers versus majority nonitemizers. If the nonitemizers prevailed politically, there would be little or no reduction in state-local taxes or services. However, if we assume that itemizers, despite their minority status, prevail politically, then state-local taxing and spending might decline by as much as 14 percent (Ladd 1984; see also ACIR 1984).

The Flat Tax and Restrictions on State and Local Bonds

The tax exempt status of interest from state and local bonds is defended on several grounds: the American federal system requires independent state and local governments whose financial instruments cannot be infringed on by the national government; the tax exemption encourages investment in state and local government and reduces interest rates for these governments; the use of this form of federal "subsidy," while less efficient than direct subsidies, allows state and local governments to decide for themselves about capital investments.

Tax reform may dramatically transform state and local government capital financing and the tax-exempt municipal securities market. There are no proposals before the Congress to tax interest on outstanding municipal bonds, and retroactive taxation would doubtlessly engender constitutional litigation. However, two provisions of the three major tax reform proposals—Kemp-Kasten, Bradley-Gephardt, and Treasury I—deserve serious attention: (1) the reduction of individual income tax rates that may reduce incentives to invest in municipal bonds and force state and local government to pay higher interest rates; and (2) the prohibition of a wide range of "private purpose" tax exempt municipal bonds.

The Modified Flat Tax and Tax-Free Yields

A great deal of speculation has centered on the effect of a modified flat tax on the ratio of tax exempt to taxable yields. If top tax rates decline, taxpayers would have less incentive to buy tax exempt municipal bonds. The yields on new and outstanding municipals would have to increase if they were to retain their attractiveness. This would make it more difficult for states and communities to finance capital improvements.

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If an investor's marginal tax rate drops from 50 percent to 35 percent, a 10 percent tax exempt municipal bond's equivalent taxable yield drops from 20 percent to 15.38 percent. Table 5 shows the effect of tax rate changes on equivalent yields.

While a decline in top tax rates theoretically should increase municipal bond yields, this effect may not be very great. First, comparing tax-exempt and taxable investments, bond buyers will still find tax-exempts producing higher real returns. Historically, changes in municipal bond yields resulting from tax rate changes have not been proportional. In 1981 when the top federal tax rate was reduced from 70 percent to 50 percent, municipal yields rose only from 81 percent of taxable Treasury returns to 91 percent.

Municipal yields today are already at historically high levels, leaving little room for major increases. Long-term municipal yields are currently at close to 90 percent of the yields on Treasuries, partly as a result of flat tax concerns, but largely because of heavy municipal supply. At present, an investor in the 15 percent federal tax bracket could do as well in municipals as with taxable Treasuries.

Restrictions on Private Purpose Bonds

Perhaps the most important tax reform proposal for state and local governments is the proposal to eliminate the tax exemption for so-called private purpose bonds, including industrial development revenue bonds, pollution control revenue bonds, owner-occupied and multi-family housing bonds, private hospital bonds, and student loan

TABLE 5

EFFECTS OF PROPOSED CHANGES IN TAX CODE ON TAX EXEMPT VS. TAXABLE GROSS YIELDS

Taxable Income[a]		Marginal Tax Rate	Taxable Equivalent for Municipal Yields of			
			8%	9%	10%	11%
50	Current	38	12.9	14.5	16.1	17.7
	Proposed	25	10.7	12.0	13.3	14.7
75	Current	42	13.8	15.5	17.2	19.0
	Proposed	35	12.3	13.9	15.4	16.9
100	Current	45	14.6	16.4	18.2	20.0
	Proposed	35	12.3	13.9	15.4	16.9
162	Current	50	16.0	18.0	20.0	22.0
	Proposed	35	12.3	13.9	15.4	16.9

[a]In thousands of dollars per joint return.

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bonds. These bonds are viewed as an important tool of state and local governments to stimulate economic development, diversify industry, provide employment, help local industry meet federally mandated pollution control requirements, expand housing and medical care facilities, and mitigate the effects of high interest rates.

Municipal bond rates are directly affected by supply and demand conditions in the municipal bond market. Few Americans realize that these private purpose, tax exempt bonds now constitute over 62 percent of the new municipal bond market (see Figure 1). These bonds have mushroomed in the market from $0.8 billion or a minuscule 4 percent of total tax-exempt offerings in 1970 to their present dominant position. Public purpose municipal bonds—revenue bonds for traditional purposes such as sewer, water, and waste treatment, and general obligation bonds for schools, police, fire, etc.—constitute only about 38 percent of the municipal bond market. All three major tax reform proposals would eliminate the tax exempt privilege of future issues of private purpose bonds.

The rationale for their elimination extends beyond the $8–10 billion in new federal revenues that would be realized if the interest on current private purpose bonds were taxable. Critics argue that these bonds do not promote economic growth, divert capital from more efficient uses in the private sector, and contribute to interjurisdictional competition without creating any net gains in employment or productivity.

Removing 62 percent of the supply of new municipal bonds from the market would have a dramatic effect in lowering municipal bond yields. States and communities would be able to fund traditional services at much lower interest costs because of the vastly reduced supply of tax-free instruments in the market. This reduction in supply would more than offset any effects of lower income tax rates.

Tax Reform: A View from the States

Tax reform is a politically popular idea, as long as it is expressed in generalities. Everyone wants a simple, fair, and efficient federal tax system; one that stimulates economic growth and does not distort market prices. The elimination of the deduction for state and local taxes, and the removal of the tax exemption for private purpose municipal bonds are desirable reforms whether or not general tax reform is achieved.

Eliminating State-Local Tax Deductibility

There are four major arguments for eliminating federal deductibility of state and local taxes:

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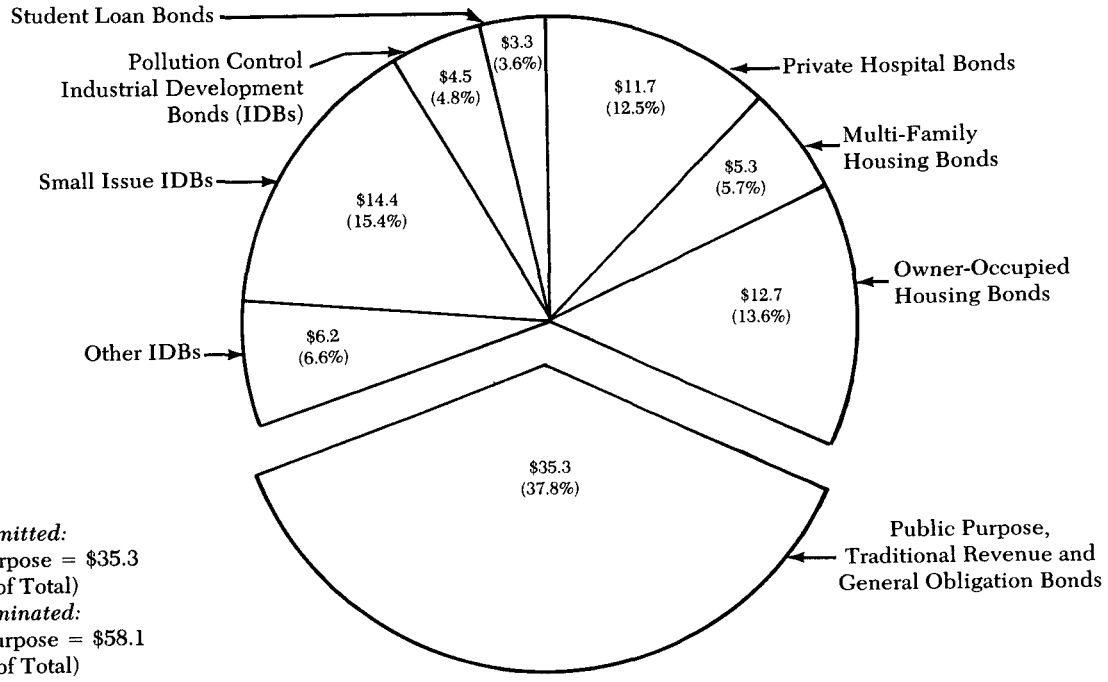
FIGURE 1

HOW TREASURY PROPOSES TO SHARPLY REDUCE MUNICIPAL BOND SUPPLY
($ Billions)



To be Permitted:
Public Purpose = $35.3
(37.8% of Total)
To be Eliminated:
Private Purpose = $58.1
(62.2% of Total)

1. Federal deductibility reduces the progressivity of state and local tax systems and converts some state tax systems into regressive ones. A common criticism of state and local tax systems is that they are regressive; this simple step by the federal government would go a long way toward ending this criticism.
2. The burden of eliminating federal deductibility will be borne by higher income taxpayers—those who will benefit most from the reduction of the top marginal tax rate from 50 percent to 35 percent. In other words, the elimination of deductibility can be presented politically as closing a loophole which primarily benefits the rich. This may help offset criticism of the flat tax concept as a benefit for the rich.
3. The elimination of deductibility will contribute to the fiscal accountability of state and local governments to their own taxpayers. Doubtless, the elimination of deductibility increases the burdens of state and local taxation. These increased burdens may place downward pressure on state and local taxing and spending. But more important, state and local taxpayers will be able to make an accurate calculation of the costs of public services without indirect federal intervention. User charges and assessments will be encouraged by the elimination of deductibility.
4. The revenue gain to the federal government from the elimination of deductibility will be significant, approximately $30 billion per year. In an era of $200 billion annual federal deficits, it is difficult to argue that state and local government taxpayers really need such a "tax subsidy."

Opposition to the elimination of deductibility can be expected from high income taxpayers in high tax states. This opposition is likely to be informed, active, skilled, and well-positioned to influence policy discussion. The people who will lose most—the high income taxpayer in high tax states—have more reason to inform and activate themselves politically, and by so doing, skew the outcome of the collective choice process in their own favor.

They may be joined by state and local officials throughout the country who understand that federal deductibility reduces the direct costs of their own taxing decisions. It may be too much to ask elected officials to give up a federal tax provision that makes the net additional tax payments less than any proposed increases for many of their citizens. They may think they "deserve a break today," especially when the federal government itself is cutting back on many

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direct grants to state and local governments, as well as general revenue sharing.

However, it is important to remember that 65 percent of the nation's taxpayers, and a majority of taxpayers in every state, do not itemize deductions. Most taxpayers will be unaffected by the elimination of deductibility.

Elimination of deductibility will certainly aggravate interstate differences in tax burdens, particularly for high income individuals. It might even contribute to migration of individuals and business from high tax states to low tax states. The incentive to migrate would be especially strong among high income taxpayers, unless the high tax states adjusted their tax schedules to discourage such migration. Still another effect might be to discourage the use of income taxes, or at least steeply progressive income taxes, by state governments. Since both federal and state rates would be additive at each income bracket, there would be pressure to reduce the progressivity of state income taxes.

Ending Tax Exemption for Private Purpose Municipal Bonds

Restrictions on tax exempt municipal bonds would also be desirable whether or not general tax reform is achieved. The social value of the municipal bond interest exemption is the incentive it provides for investment in public infrastructure—schools, hospitals, streets, sewers, airports, etc. Certainly the recent estimates of heavy infrastructure investment required in the United States over the next 20 years warn us not to tamper with this important incentive as it affects these basic public needs. We are aware, of course, of the liberal argument that the municipal bond interest exemption is "an ineffective type of subsidy" for public infrastructure, that "the saving in interest payments by state and local government is less than half the revenue loss to the federal government," and that there are "less costly . . . and more equitable ways to assist or subsidize state or local government" (Peckman 1984, p. 119). But those of us with "a bias toward federalism" and a preference for decentralized decision making in a large democracy, will continue to support a type of "subsidy" which minimizes federal involvement.

However, when state and local governments issue tax exempt securities to finance business enterprise, or apartment complexes, or single-family housing developments, they direct capital away from the private market and disadvantage business and developers who do not claim these public subsidies. Abusive examples of so-called industrial development bonds providing low interest capital funds for private firms are numerous. The explosive growth in the volume

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of mortgage subsidy bonds and industrial development bonds to well over half of the municipal bond market should itself provide a warning of the potential for abuse in these issues. Elimination of private purpose bonds would have little effect on the nation's net industrial employment or productivity, but it would moderate some interjurisdictional competitive practices.

The removal of tax exemption from these private purpose municipal bonds would reduce significantly the cost of financing traditional public services. In recent years the municipal bond market has been affected more by supply changes than any other factor. Eliminating the tax exemption on new issues of private purpose municipal bonds would reduce the supply of new municipal issues by over half and dramatically reduce yields on the remaining public purpose municipal offerings. This would produce a substantial savings for state and local governments in financing public improvements and encourage the rebuilding of America's infrastructure.

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TAX REFORM: SOUND ECONOMICS OR POWER POLITICS?

Susan B. Hansen

The disciplinary bias of the economics profession is to analyze specific aspects of tax reform proposals. Political scientists, however, are less given to precisely defined models. Instead, many of us suspect that the elegance of a model is inversely proportional to the generality of its results. Further, in the real world of politicians and policymakers, it is frequently necessary to evaluate several competing values or outcomes without the luxury of "holding constant" other confounding factors.

Such is manifestly the case with respect to any reform in the federal income tax which affects the deductibility of state and local taxes. Flat tax reform proposals may suggest benefits such as greater simplicity, increased popular support for the tax code, lower business costs, incentives for human capital investment, or enhancement of the political fortunes of the president or members of Congress. But all such changes have consequences for fiscal federalism and are thus a matter of great concern for state and local governments and taxpayers.

The arguments for and against ending deductibility are summarized by Dye (1985). He also presents evidence as to which states will be the "winners" and "losers" under the proposed provisions. It is interesting to note that deductibility changes several state tax structures from progressive to regressive. Dye then turns to the impact of ending deductibility for interest from "private purpose" municipal bonds. He argues that bond yields would fall and that state and local governments would find it easier to raise capital funds at reduced costs. Dye's paper was written before President Reagan's version of tax reform, termed the "Second American Revolution," was actually introduced.

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Since then, several events have led me to conclude that Dye may have underestimated the political opposition to ending state/local tax deductibility. First, a *Newsweek* survey (10 June 1985) reported that many who do not itemize, and thus do not currently benefit from state/local tax deductibility, nevertheless oppose ending it; the margin was 54 percent to 37 percent. As is often the case, the economic rationale underlying such survey responses is somewhat obscure. Some people may not understand the issue, or they may favor federal aid to state and local governments as a matter of principle. Others may hope to itemize at some future date, or may feel that deductibility is part of the potential value of their property. Regardless of the reasoning (or lack thereof), popular support for ending deductibility appears weak.

Second, people who do itemize or who otherwise favor retaining deductibility, are in a position to exert more political influence than lower income taxpayers who would benefit from ending deductibility. A Massachusetts survey found that 56 percent of voters in the 1980 elections itemized, although only 37 percent of all taxpayers did so (ACIR 1984). Property owners are more likely to favor deductibility and are also more likely to be politically active.

Third, proponents of state/local deductibility are not without influence in Congress. Robert Packwood of Oregon, a state with fairly high and progressive taxes, is chairman of the Senate Finance Committee and has already voiced serious reservations on this point. The vocal protests of New York Democrats such as Governor Cuomo or Senator Moynihan may be written off as partisan politics. But many other senators and representatives from both parties are former mayors, governors, or state legislators, or have close contacts with state/local officials; their protests cannot so easily be dismissed. Also, a number of Republican senators facing reelection are from high-tax states.

Finally, state and local officials, and not just those from high-tax states, have raised strong objections to ending deductibility and to changes in the tax-free status of bonds. The U.S. Conference of Mayors, for example, recently announced its opposition because of concerns for economic development financed by industrial revenue bonds (IDBs). Dye and the flat tax proponents suggest a straightforward distinction between public purpose bonds and private purpose bonds, but in practice the distinction is hard to maintain. Local officials see strong public benefits to financing structures such as airports, hospitals, colleges, and pollution control via IDBs. The issue, of course, is the purpose of government, not just a minor change in the tax code.

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Since so many other tax preferences are also politically controversial, I will hazard no guesses at this point as to the likelihood of ending deductibility. It might be fruitful, however, to speculate on possible consequences of *not* ending deductibility. At worst, it could jettison the whole tax reform effort because the revenue loss from this one deduction (estimated at $30 billion in FY 1985) is so large. If deductibility fails, overall tax rates must either increase or the personal exemption must be reduced to avoid a revenue loss. And if one such "tax expenditure" is retained, all the other loopholes are vulnerable. But this may be moot; the president already has backed down on the issue of intangible drilling costs. In short, the whole tax reform effort already has been moved from economics to power politics.

Also, if deductibility is retained, the federal government will remain involved with state/local finance, to the tune of $30 billion yearly in tax subsidies. To many this is a positive benefit, to say nothing of the constitutional issues involved in double taxation. Nevertheless reform efforts merit serious consideration, whether or not they are part of a comprehensive flat tax package. If one favors some form of federal financial assistance to states and localities, surely measures can be found that are less regressive and that do not favor wealthier states. Given the current federal deficit and state/local surplus (over $50 billion in FY 1985), however, it will be difficult to construct any coalition in favor of some new form of revenue sharing, even one targeted at the poorer states.

In conclusion, I must question Dye's expectation that states will be forced to reduce spending if the state/local tax deduction is ended. Similar forecasts were heard in the aftermath of Proposition 13. The experts and the voters, however, underestimated politicians' ingenuity in devising new sources of funds (Hansen 1983). One method was to increase user fees—a tax by any other name. Another was to "reform" state tax systems via what George Will has termed "loophole-closing compliance-inducing revenue enhancers." A third was to increase borrowing—per capita state debt has nearly doubled since Proposition 13 passed. As shown by Dye's thoughtful analysis of the 1981 changes in tax-exempt bond provisions, it should be easier for states and localities to raise funds to finance capital expenditures. In addition, tax revolt sentiment has already led state and local governments to cut costs and improve productivity. Further reductions must therefore come at the expense of service provision in popular areas such as education or recreation. Faced with such choices, voters in several states have rejected further tax cuts; state/local revenue as a percent of GNP has declined only a fraction of a percent since 1978. Even if his proposed flat tax passes, therefore, President Reagan may

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have no more success in reducing state/local spending than he has had in cutting the federal budget.

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PUBLIC CHOICE PERSPECTIVES ON THE FLAT TAX FOLLIES

Thomas S. McCaleb

Introduction

Most experts agree that the existing income tax system is grossly inefficient. It distorts the income-earning and expenditure decisions of individual taxpayers, inducing them to choose less-preferred alternatives that are eligible for favorable tax treatment in place of more-preferred alternatives that are not so favored by the tax system. The progressive rate structure, for example, alters choices about the division of income within the family and about the timing of income receipts and expenditures. The exclusion of some types of income and the favorable tax treatment accorded other types of income distort choices about working, saving, and investing; and the granting of exemptions, deductions, and credits distorts decisions about private activities and expenditures. Such distortions impose unnecessary costs on the individual taxpayer over and above the tax liability itself that could be avoided simply by restructuring the tax system.

This view underlies such flat tax reform proposals as the Bradley-Gephardt Fair Tax Plan and the Treasury's 1984 comprehensive income tax plan (Treasury I). These proposals would reduce both the number of tax rate brackets and the level of marginal tax rates, would impose a tax on many types of explicit and implicit receipts that are now excluded from the concept of taxable income, and would "close loopholes" by repealing most exemptions, deductions, and tax credits. Because there is widespread agreement that the flat tax is clearly more efficient than the existing income tax structure, the debate over the relative merits of the two systems has focused primarily on questions of fairness and equity.

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In fact, however, the flat tax only appears to be more efficient because of the restrictive concept of efficiency employed in the traditional approach to the study of tax policy by economists as well as other policy analysts. An investigation of the characteristics of an efficient tax structure from the broader public choice perspective reveals that graduated rates, exclusions, and deductions may be quite consistent with economic efficiency, taking into account all the dimensions along which individual choice proceeds.

This article examines the efficiency properties of the current income tax from a public choice perspective. Three different models of public choice—the private exchange model, the fiscal exchange model, and the Leviathan model—are used, and it will be seen in each that the existing income tax system appears more efficient and the proposed flat rate tax appears less efficient than has so far been recognized. The analysis begins by comparing the traditional approach to the analysis of tax policy with the public choice approach.

Alternative Approaches

The traditional approach to the study of taxation and its effects completely ignores the political dimension.[1] It implicitly assumes that individual taxpayers do not make choices either directly or indirectly about fiscal rules and institutions or about public expenditures and revenues, or at least it does not subject such choices to economic analysis. Accordingly, decisions about the rules and institutions that govern society and decisions about the level and composition of the public budget are made outside the system and imposed on it. The taxpayers then make their market choices about earning, spending, and saving in an economic environment shaped by these externally imposed rules, institutions, and budgets. The taxpayers have no influence over the economic environment; they merely react to it in their market behavior.

The only problem for analysis in the traditional approach is the effect different fiscal institutions have on market choices. The influence of the same fiscal institutions on political choices remains unexamined. From this perspective, any tax rule that alters the income or expenditure decisions of individuals in the market is inefficient, and the greater the distortion, the greater the inefficiency. The present income tax is grossly distortive of these decisions and therefore decidedly inefficient. A flat tax is demonstrably less distortive and

[1]An excellent textbook introduction to the traditional approach is Musgrave and Musgrave (1984). The traditional approach is also exemplified by Pechman (1983).

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therefore clearly superior (Hall and Rabushka 1983; Treasury I 1984, vol. 1, chaps. 1–3).

The public choice approach, on the other hand, recognizes that in a democratic system government expenditure and revenue decisions emerge from the interactions and reflect the preferences of the individual voter-taxpayers.[2] Ultimately, individuals make these decisions through the political process. Both the traditional and the public choice approaches examine the effects of fiscal rules and institutions on individual choices in the market, but the public choice approach also investigates the influence of these rules and institutions on political choices and on public spending. From the public choice perspective, decisions about the size and composition of the public budget are not independent of the fiscal institutions. Instead, there is a feedback effect from the institutional structure to the public budget that is altogether ignored by the traditional approach. Furthermore, the public choice approach recognizes that ultimately the fiscal rules and institutions themselves are derived from the choices of the individual voter-taxpayers. The public choice approach, then, is more complete than the traditional approach, taking into account additional dimensions of individual choice.

From the public choice perspective, fiscal institutions that alter individual decisions in the market are inefficient. However, fiscal institutions also affect individual voting decisions, generating an additional source of inefficiency not recognized by the traditional approach. A comparison of alternative rules and institutions, including tax rules, in terms of their effects on economic efficiency must then take into account both market and political choices, which the traditional approach fails to do. For these reasons, the traditional analysis of tax policy is misleading. When public choice considerations are introduced, the flat tax is no longer clearly superior to the existing income tax on efficiency grounds. Whatever the relative merits of the flat tax in its effects on individual choices in the market, its effects on political behavior must also be considered, and along this dimension the existing income tax may be superior.

Unlike the static single-dimensional setting of the traditional approach, the public choice approach includes different levels of decision making occurring at different points in time. Individuals first choose a set of fiscal rules and institutions at a "constitutional"

[2]See Buchanan (1967, 1975, 1976) for a discussion of the distinguishing features of the public choice approach.

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decision level.[3] These rules and institutions are intended to be relatively permanent. Once this constitutional framework has been erected, operational choices about the level and composition of public spending and about individuals' earning, spending, and saving activities in the market are made. These postconstitutional decisions are less permanent than the constitutional decisions, and a whole sequence of operational decisions may be made under a single set of fiscal rules and institutions. This political setting is analogous to the playing of a game. Before the cards are dealt and play begins, a set of rules is adopted. Then, within the framework established by these rules, the hands are dealt and the play commences. Many hands may be dealt and many rounds played using a single set of rules.

The structure of the tax system is among the fiscal rules and institutions determined constitutionally. Major changes in tax policy occur only infrequently, whereas public expenditure decisions are made annually and individual market choices take place almost continuously.[4] Because the constitutional decisions are made less frequently and are more permanent than the postconstitutional choices, individual voter-taxpayers are less certain at the constitutional level about the impact that the chosen rules and institutions will have on their own economic and social position within the community. The greater uncertainty about individuals' private self-interest at the constitutional level encourages the choice of efficient rules and institutions, that is, rules and institutions that will promote efficiency in the subsequent postconstitutional market and political choices.

In this political setting, many features of the existing tax structure may well be consistent with economic efficiency. Considered only

[3]The concept of a constitutional level of decision making is not related to the formal process of establishing a written constitution at the inception of the state. It refers instead to the fact that certain legislative acts are more permanent than others and are intended to remain in effect and substantially unchanged for relatively long periods of time. In contrast, other legislative acts, such as decisions about the level of government spending, are made one year at a time. The demarcation of the choice process into constitutional and operational levels originated with Buchanan, who has developed this framework of analysis in a series of works. For a more complete discussion of this two-stage decision process, its characteristics, and its implications, see Buchanan and Tullock (1962) and Buchanan (1967, 1975).

[4]There has been a reversal of this historical experience in recent years. Congress has passed a set of entitlement programs with established eligibility rules and formula-determined benefit levels. Annual expenditure on the programs depends entirely on these rules instead of on an annual appropriation decision. On the other hand, major changes in tax policy have occurred more and more frequently. Indeed, since 1981, significant new tax legislation has been enacted every year. This perversion of the normal legislative process is reason enough not to adopt any major tax reform proposal for some years to come. A moratorium on new tax legislation for a period of, say, five years would be a most appropriate policy action.

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in terms of their impact on postconstitutional choices about private income-earning and expenditure activities, these features appear to be economically inefficient, as the traditional approach suggests. But considered in the broader public choice context, which takes into account not only choices about private income-earning and expenditure activities but also choices about the size and scope of government, these features may indeed be conducive to greater efficiency in the allocation of economic resources.

Private Exchange Model

Of the three public choice models, the private exchange model is closest in spirit to the traditional approach. The model permits only two types of decisions—the constitutional choice of a set of tax rules and the same postconstitutional choices about income-earning, saving, and spending that are the principal focus of the traditional approach. Unlike the traditional approach, however, the private exchange model recognizes that a range of market decisions will be made over time subject to a single invariant set of tax rules. It is therefore necessary to take into account the impact of the tax rules not just on the efficiency of the choices made at a single instant of time but on the efficiency of the whole sequence of decisions. Thus, even though this model restricts individual choice to only two dimensions, it is nevertheless more general than the static single-dimensional setting of traditional analysis.

In the private exchange framework, individuals at the constitutional level rationally may choose highly progressive income taxes as a way of smoothing their disposable income over time so that it conforms more closely to their desired consumption spending. Suppose that the taxpayer must over several periods pay a tax liability with a fixed present value; that his income fluctuates over time but his consumption expenditures are relatively constant; and that capital markets are imperfect so that the taxpayer can lend at the same interest rate as the government (by purchasing government bonds), but the government's borrowing rate is less than the borrowing rate available to the taxpayer. With fluctuating income, the taxpayer typically reduces his saving and his spending on consumer durables when current income declines below his anticipated long-term average income (often called his permanent income) in order to maintain his nondurable consumption expenditures. Later, when current income rises above permanent income, the taxpayer again maintains his nondurable consumption spending, using the extra income for saving and for purchasing consumer durables.

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Greater efficiency in the timing of saving and spending on consumer durables could be achieved if the taxpayer were to borrow during periods of low income and pay back his borrowings during periods of relatively high income. A progressive income tax, in effect, provides a mechanism by which the taxpayer can do just this. It is tantamount to borrowing through the government at the government's more attractive interest rate. When current income falls below the long-term average, tax liability decreases more than proportionately so that a larger share of income is available for saving and for spending on consumer durables. On the other hand, when current income rises, tax liability rises more than proportionately, in effect imposing an implicit interest charge on the previous "borrowings."[5]

Of course, a progressive income tax distorts individuals' static income-earning choices more than does an equal-yield proportional income tax. However, the gain in static efficiency that would result from adoption of a flatter rate structure must be balanced against the loss in efficiency arising from greater intertemporal fluctuations in saving and spending on consumer durables. Thus, the taxpayers may prefer greater progressivity, despite its static inefficiencies; if this is true, then adoption of a flatter tax is *a fortiori* inefficient. What the public choice approach recognizes and the traditional approach ignores is that taxpayers have preferences about the tax structure itself that can be independent of their own tax liability.

The exclusion of some sources of income from the tax base makes fluctuations in disposable income smaller than the fluctuations in before-tax income and permits the taxpayer to maintain a smoother time profile of saving and spending on consumer durables in the same way that progressivity does. These exclusions from taxable income are, in the traditional approach, clearly inefficient because they distort the income-earning choices of taxpayers. Once again, however, from the public choice perspective, the static inefficiencies in individual income-earning decisions may well be offset by the greater efficiency in intertemporal saving and spending decisions. Taxpayers may therefore quite rationally prefer at the constitutional level a tax structure that excludes some types of receipts from the tax base without regard to their own tax liability, and the elimination of such exclusions would therefore be inefficient.

Like progressivity and income exclusions, tax deductions can also bring greater efficiency to individuals' intertemporal saving and

[5]The notion of permanent income and the theory of consumption and saving that derives from it were originally developed in Friedman (1957). The application of the permanent income hypothesis to the analysis of efficient tax structures is found in Buchanan (1967, chap. 15).

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spending decisions. Saving and spending on consumer durables may depend not on disposable income, but rather on discretionary income—that is, income that remains after taxes and after certain "necessary" expenses. If, for example, the taxpayer incurs heavy medical expenses, then his discretionary income may fall even though his current income is unchanged. As a result, saving and spending on consumer durables would be adversely affected, leading to an inefficient pattern of saving and spending over time. This inefficiency can be reduced, however, if tax liability is reduced, freeing more of the taxpayer's total income for other expenditures. By including a deduction for medical expenses in a progressive income tax structure, allowances are made for fluctuations in discretionary income that do not correspond to fluctuations in before-tax income. With progressive rates, the deduction is tantamount to providing a loan to the taxpayer at the government's more attractive interest rate to cover the extraordinary expenses. In this view, "closing loopholes" may be a distinctly inefficient policy.

In the context of the private exchange model, then, progressive rates, exclusion of some forms of receipts from the income tax base, and allowance of deductions for certain individual activities and expenditures are often efficient. This conclusion contrasts sharply with that reached by the traditional approach because it takes into account more dimensions of individual choice. Furthermore, the private exchange model recognizes that tax structures remain in effect for many years and that individual decision making proceeds over time subject to a relatively fixed set of tax rules.

Fiscal Exchange Model

The fiscal exchange model extends the range of individual choice to include postconstitutional decisions about the level and composition of government spending. Individual voter-taxpayers make decisions at the constitutional level about the tax rules. At the postconstitutional level they make their income-earning, saving, and spending choices, as well as express through voting their preferences about public spending. The actual postconstitutional decisions about public spending are made either by direct referendum or by the voters' representatives in a legislative body. The representatives are assumed to express in their own voting the collective preferences of their constituents.

These preferences are shaped by the distribution of the taxes required to finance the public expenditure. Efficient public expenditure decisions, therefore, are promoted by a system that distributes

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taxes in proportion to the values placed on publicly provided goods and services. In the fiscal exchange model, then, individuals at the constitutional level may choose a tax structure that maximizes the anticipated efficiency of postconstitutional decisions by ensuring that the distribution of the tax burden corresponds as closely as possible to the expected distribution of benefits from public spending.

If the voter-taxpayers believe that demand for public spending is directly related to income, then taxes too must depend on income. If the value derived from public spending were just proportional to an individual's income, then a proportional income tax would be efficient. On the other hand, if the value of public services increased more than proportionately with income, then progressivity would be required (Buchanan 1964; McCaleb, forthcoming). In this event, the flatter tax will distort individual choices, expressed through voting, about the level of public spending. The result may be a public budget that is either too large or too small. Thus, while a flatter rate structure may reduce distortions in income-earning and spending decisions, this greater efficiency in the market may come at the expense of less efficiency in the fiscal exchange process. Only by ignoring the interdependence between tax rules and spending decisions, the traditional approach concludes that a flatter tax is unambiguously more efficient than the existing progressive income tax.

The fiscal exchange model also shows the potential importance of exclusions and deductions in an efficient tax system. If the value of public expenditures to individuals is unrelated to certain sources of receipts, these sources must be excluded from the tax base in order for the tax burden to be distributed in proportion to the value of public services. To include such sources in the concept of taxable income, then, might improve the efficiency of individuals' income-earning choices, but only at the expense of less efficiency in public expenditure.

The income tax rate structure promotes efficiency in the fiscal exchange process if it reflects differences among individuals in the value of public spending that are related to income differences. However, even among individuals with the same income, differences in the value of public spending may exist. For example, the value of public expenditures may be lower to those with heavy medical expenses or property losses or unusually high occupational expenses. Including deductions in the tax structure adjusts for differences in individual demands that are unrelated to income differentials (Lindsay 1972; McCaleb, forthcoming). Deductions for these types of market expenditures, therefore, are conducive to more efficient choices in the fiscal exchange process—in other words, greater efficiency in

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the size of the government's budget—even if they impose some inefficiency in market choices. Tax simplification through loophole closing does not necessarily represent a net efficiency enhancement.

Tax deductions may encourage greater efficiency in the composition of the public budget as well as in its size. Two people with the same income may prefer the same level of public spending but disagree on the composition of that spending. By allowing them to take deductions for their own expenditures on certain items, the government in effect provides a matching grant. Thus, the composition of public spending more closely reflects the preferences of individual voter-taxpayers, and the fiscal exchange process is more efficient even if there is some loss of efficiency in the individuals' market choices. Tax deductions represent a relatively low-cost mechanism for discovering such variations in individual preferences and for implementing a public budget that takes better account of these variations.

Although the fiscal exchange model focuses on a different dimension of individual choice than does the private exchange model, the conclusions are similar. Progressive rates, exclusion of some sources of income from the tax base, and allowances for tax deductions have the potential for enhancing efficiency in public expenditure. Even though these features of the tax structure may be inefficient in their effects on individual income-earning, saving, and spending decisions, these inefficiencies must be balanced against the greater efficiency in the level and composition of public expenditure.

Leviathan Model

In the fiscal exchange model politicians and bureaucrats play an essentially benevolent role. They are implicitly assumed to respond to the collective preferences of the individuals in the community as reflected through voting. An alternative view, made popular by the emerging economic theories of bureaucracy (Niskanen 1971; Breton and Wintrobe 1982), sees politicians and bureaucrats in an altogether different and somewhat malevolent light. In this government-as-Leviathan framework, politicians and bureaucrats make all postconstitutional decisions (Brennan and Buchanan 1977, 1980). Furthermore, their decisions reflect their own interests and not those of the individual voter-taxpayers. The politicians and bureaucrats promote their interests by making decisions that maximize the government's revenues and minimize expenditures on socially beneficial goods and services. The politicians and bureaucrats are, however, constrained by the tax rules adopted at the constitutional level.

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Thus, the problem facing the voter-taxpayers is to devise a set of constraints that will minimize the surplus of revenues over expenditures that the politicians and bureaucrats can obtain and that will also provide appropriate incentives for them to make efficient decisions about the level and composition of government spending.

Suppose that individual demands for income-earning activities are like their demands for other activities, that is to say, they are downward-sloping. Applying regressive rates to any income base, then, allows the politicians and bureaucrats to tax additional dollars of income at lower and lower marginal rates. They thus obtain ever more revenue unconstrained by the adverse effects of high tax rates on the incentives to earn income. Proportional or progressive rates, on the other hand, provide greater disincentives to earn additional income than regressive rates do, and therefore these rates more effectively limit the amount of revenue that the politicians and bureaucrats can extract. Indeed, progressive rates may be even more restrictive in this regard than proportional rates. As a result, a constitutional requirement of progressive rate taxation can be an effective constraint on the incentives of politicians and bureaucrats to expand revenue collections and public spending beyond the efficient level.

Of course, different individuals respond differently to taxes in making their income-earning choices, and the proportion of income that can be extracted from any one individual will be smaller the more responsive is that individual. If each individual could be taxed at a different rate, the politicians and bureaucrats could extract the maximum possible revenue from each one. By requiring uniform rates among all individuals at the same income level, however, such discrimination is prevented. The more responsive is any one individual in the community, the lower will be the revenue-maximizing tax rate imposed on all, and the more limited will be the ability of the politicians and bureaucrats to expand the public sector beyond the efficient size.

The efficient level of public spending is almost certain to be less than could be financed by a revenue-maximizing tax imposed on a comprehensive income base. Thus, constraints imposed at the constitutional level restrict the total tax base available to the politicians and bureaucrats. The exclusion of some sources of receipts from taxable income and the allowance of deductions for certain types of individual activities and market expenditures provide such a restriction.

In the traditional approach, spending and taxing decisions are treated as if they were independent and unrelated. Therefore, it would be impossible for voter-taxpayers to influence the govern-

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ment's spending decisions by attempting to impose constitutional constraints in the form of tax rules. Furthermore, it is unnecessary to do so in the traditional view because spending and taxing decisions are made by a benevolent government whose only interest is the maximization of social welfare. If, however, politicians and bureaucrats have some capacity for independent self-interested behavior, the possibility of using tax rules to promote more efficient expenditure decisions by the government clearly emerges. Progressive rates, income exclusions, and deductions all provide such constraints. Once again, by expanding the notion of efficiency to include the full range of individual choices, it becomes apparent that flatter tax rates and more comprehensive tax bases are not necessarily conducive to greater efficiency in the broader sense.

Conclusion

Like all economic models, each of the public choice models examined here represents a simplification of and an abstraction from individual behavior in the real world. Nevertheless, each model does capture important elements of reality. It is both comforting and significant that the conclusions derived from any one of the models about the characteristics of an efficient tax structure are affirmed by each of the others. The private exchange model recognizes the time dimension in individual decision-making and the interdependence among choices made at different points in time. It also recognizes that individuals will have preferences about alternative tax rules that are independent of their own liability under those rules and that these preferences will reflect the time dimension and the intertemporal interdependence of their choices. The fiscal exchange model takes into account individual preferences about public spending and how such preferences influence public expenditure decisions. In particular, this model captures the important impact of tax rules on public expenditure decisions. Finally, the government-as-Leviathan model allows for the discretionary behavior of politicians and bureaucrats. Instead of treating these players as mindless automatons, it makes them fully participatory actors in the political drama, and it then takes into account the influence of their behavior on the efficiency of public expenditure decisions.

In the context of each of these models, highly progressive tax rates, exclusion of some income sources from the tax base, and allowance of tax deductions are perfectly consistent with economic efficiency. Only within the narrow confines of the traditional approach to tax analysis do these features of our existing income tax structure have

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an unambiguously pernicious effect on economic efficiency. By restricting the definition of efficiency so as to exclude from consideration the wide range of individual choice, the traditional approach has eliminated efficiency as a criterion for choosing between the current system and the proposed flatter rate taxes. The flatter tax wins by default. But in truth this approach has little or no relevance for the real world of tax policy. And when the concept of efficiency is expanded to include the full range of individual preferences and decisions, the superior efficiency of the flatter tax is no longer obvious. Considerations of efficiency once again enter the debate over tax reform equally with issues of fairness and equity.

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PUBLIC CHOICE AND THE FLAT TAX

Marilyn R. Flowers

Is public choice hostile to the flat tax? This is a major theme of McCaleb's paper.[1] In support of his thesis, he cites three models, each of which falls under the general rubric of public choice or, more specifically, constitutional contractarianism, and each of which offers normative support for some departure from a comprehensive tax base and in favor of a progressive rate structure. Consequently, McCaleb argues that any or all of the models offers a legitimate challenge to the current popular thrust in tax reform which favors less progression and a significant broadening of the tax base.

McCaleb's description of the models and of their implications is accurate as far as it goes. However, some questions can be raised about their relevance to the current tax reform debate. This is particularly true with respect to the private and fiscal exchange models. These questions will be the primary focus of this comment. In addition, McCaleb's more general, implied contention that public choice is necessarily hostile to the flat tax will be challenged. Arguments favorable to that tax can be developed from a public choice perspective.

The private exchange model examines the tax code as a second best alternative to a (presumed nonexistent) perfect capital market. If tax institutions are perceived to be at least quasi-permanent, their design can be used to adjust intertemporal consumption patterns. From this perspective, plausible arguments are offered that individuals might prefer certain departures from a comprehensive base and also progressive rather than proportional rates. Both can be a means of smoothing intertemporal consumption patterns relative to income flows.

The relevance of this analysis to the current tax reform debate seems limited. Few of the tax preferences which flat tax proponents

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and other reformers seek to end could plausibly be supported using the private exchange perspective. Why would individuals support tax rules that cause them to systematically underestimate the costs of public services (state and local tax deductibility) or which lead to gross misallocation of investment spending (the Accelerated Cost Recovery System and numerous other special investment provisions)? In addition, because high income taxpayers take disproportionate advantage of itemized deductions, tax preferences offset rather than complement the progressivity which is supported by the private exchange model.

If support for progression is to emerge from the private exchange model, individuals must perceive significant stability in taxing institutions. As McCaleb notes (in footnote 4), this is hardly consistent with actual experience during the past 15 or so years which witnessed passage of numerous major pieces of tax legislation. This is an important point and deserves more consideration than it receives in his paper. How are voter attitudes toward tax preferences and progressivity changed if the long-term "constitutional" perspective implicit in the private exchange model is absent? It seems clear that prospects for short-term gain would be dominant with the tax legislative process becoming a classic exercise in rent-seeking.

The rent-seeking model seems the most plausible explanation of the current tax code with the corresponding implication that piecemeal tax reform is a negative sum game. This suggests that significant gains could be possible if comprehensive tax reform were to encompass changes in tax institutions that would curtail incentives for coalitions of taxpayers to use the tax code as a device to redistribute wealth to themselves. The flat tax may offer some hope in this regard. Political jockeying for reductions in relative tax shares centers on the definition of the tax base and, to a lesser degree, on manipulation of tax rates. Agreement on a single rate applied to a well-defined comprehensive base with *no* tax preferences might be possible if voters were fully appreciative of the long-term consequences of rent seeking. This perspective on tax reform does not deny that some departures from a comprehensive base such as those identified by the private exchange model might be efficient. Rather it recognizes that the democratic political process is poorly suited to distinguish between efficient and perverse tax preferences. Forgoing the former category of preferences may be a small price to pay if that is a means of avoiding the costs associated with the latter.

The fiscal exchange model offers the perspective of the progressive income tax as a reasonable approximation to a Lindahl-type benefit tax. As is the case with the private exchange model, the relevance of

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this perspective to the current tax debate is questionable. In particular, the model rests on the arguable validity of three separate assumptions which are made either explicitly or implicitly in the discussion. These are (1) that the income elasticity of demand for public goods exceeds one; (2) that taxation is the marginal source of public revenue; and (3) that the government budget is devoted primarily to outlays for public goods.

A progressive income tax may approximate a benefit tax or it may not. Specific exclusions from income may be comparable to efficient matching grants or they may not. Specific conclusions would require empirical evidence about individual preferences. Have empirical studies been done that support the hypothesis that the income elasticity of demand for public services exceeds unity? McCaleb cites no such studies and in their absence, as he himself notes, the fiscal exchange model can suggest only a *possibility* that progression reflects the benefit principle of taxation.

Even if a progressive income tax were to assign tax shares that were roughly in accord with individual demand for public services, efficient voting on the public budget would require that the income tax be the relevant determinant of *marginal* tax prices. Two institutional considerations weaken this argument considerably. The first is that debt rather than tax finance is clearly the marginal funding source for the federal government. Unless voters correctly perceive and capitalize the future tax liability resulting from creation of public debt, the tax prices implicit in the income tax are inframarginal and not the determinants of public spending.

The second institutional consideration has to do with the fact that most Western democracies, including the United States, are heavily involved in transfer spending in addition to outlays for more traditional public goods. Most governments lump transfers and public goods expenditures into a single unified budget. A common budgeting institution involves separate decisions on the size of total spending and the allocation of that total. If public goods are financed on the margin from reduced transfer spending rather than increased tax revenues, voter perceptions of the marginal cost of public goods will be determined by their expected shares in the transfer component of the budget rather than the shares implicit in tax institutions. Even if the income tax assigned tax shares that corresponded roughly with individual marginal evaluations of public goods, budgeting institutions could prevent efficient spending levels from being achieved.[2]

[2]See Flowers and Danzon (1984) for a more complete discussion of this and related points.

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The preceding discussion suggests that the case for progressive taxation which emerges from the fiscal exchange model is, at best, ambiguous. The relevant policy issue would seem to be whether or not the possibility that a progressive tax might be a benefit tax is sufficient justification for that form of taxation. In this author's opinion, the fiscal exchange model cannot counter the arguments against progression that arise from considerations of excess burden, rent seeking, and the potential for a purely arbitrary assignment of tax shares emerging from the political process.

The Leviathan model offers the strongest case for progressive taxation of a narrow base. The model relies on a profoundly pessimistic view of majoritarian political process. If one shares this view, the implication of the model seems inescapable. Clearly most proponents of the flat tax do not have such a dismal perception of democratic politics.

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WHY NOT A TRUE FLAT RATE TAX?

Edgar K. Browning and Jacquelene M. Browning

Introduction

A true flat rate tax on income has two characteristics: first, the tax base is a comprehensive measure of income with no preferential treatment given to specific sources or uses of income, and second, a single tax rate is applied to that base. In short, a flat rate tax is a proportional tax on total income. By contrast, all of the proposals for reform of the federal individual income tax that have received serious attention are so-called modified flat tax proposals. They differ from a true flat rate tax by using a less comprehensive definition of taxable income (though often more comprehensive than under current tax law) and by applying a small number of graduated tax rates to that base. Since any of the modified flat tax proposals are more complex, more inefficient, and more horizontally inequitable[1] than a true flat rate tax, why are modified flat rate tax proposals considered the only serious contenders in the tax reform sweepstakes?

There is, of course, a simple answer to that question, an answer that seems to be almost universally accepted. In the words of the recent Treasury Department study on tax reform options (Treasury I 1984, pp. 21–23):

> These important advantages [of the flat rate tax] must be compared to the troublesome distributional implications of a pure flat rate tax. A single, totally flat rate, whether imposed on income or on consumption, would involve a substantial shift of tax burden from those in the highest income brackets to low- or middle-income taxpayers.

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[1]Horizontal inequity refers to the imposing of different tax burdens on people with equal ability to pay taxes. In other words, two people with the same incomes may pay different taxes because one makes greater use of tax preferences.

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> . . . Because of the massive redistribution of tax burdens a pure flat tax would produce, the Treasury Department recommends against its enactment.

Put differently, a true flat rate tax is thought to harm low- and middle-income taxpayers, a politically unacceptable consequence. Although there may be other disadvantages to the flat rate tax, this is the only one the Treasury Department mentions, and we suspect it is the principal objection most people have to the idea of a true flat rate tax.

The primary purpose of this paper is to examine carefully this objection to a true flat rate tax. Basically, we show that a flat rate tax will harm lower income households to a much smaller degree than is generally believed or estimated, and may even benefit them over the long run. Our conclusions follow from an analysis that incorporates the efficiency gains from the tax reform as offsets to the direct effects of changing tax liabilities.

The Economic Effects of Flat Rate Taxation

In examining the effects of a flat rate tax, we assume that a flat rate tax is substituted for the present federal individual income tax and that the single tax rate is set so that government revenues remain unchanged. In this framework, it is reasonable to suppose that government expenditure policies do not change, so we can concentrate on the consequences brought about by the change in tax policy alone. As will become clear, most of the advantages expected from this change in tax policy are really the alleviation of the disadvantages of the current income tax.

One of the most important advantages of the flat rate tax is that it will improve incentives to produce by reducing the marginal tax rates of most or all taxpayers. It is important to recognize that the marginal tax rate that applies to the earnings of productive resources is what produces adverse effects on resource supplies. If the marginal tax rate is 40 percent, for instance, a person who has an opportunity to earn an extra $100 will decide whether it is worth the effort based on the $60 in after-tax income that he gets to keep. The higher the marginal tax rate, the lower is the net rate of remuneration received and the more adversely resource supply is likely to be affected. Currently, marginal tax rates under the federal income tax range from 11 percent to 50 percent. In 1979, 35 percent of taxpayers filing joint returns faced marginal rate brackets of 28 percent or higher, and 13 percent were in marginal rate brackets of 37 percent or higher.

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Under a flat rate tax using a comprehensive definition of income, the single marginal rate used could be as low as 10 to 12 percent. Thus, most or all taxpayers would confront a substantially lower marginal tax rate, and this in turn means the after-tax reward for earning more income would be increased. Although the magnitude of response to the higher after-tax returns is disputable, recent empirical research as well as common sense suggest that people will choose to make greater efforts to earn income when the returns are higher. These efforts could take the form of increased labor supply or increased saving and investment (or both).

Two further advantages can be expected from the use of a comprehensive measure of income coupled with a low marginal rate. Currently, taxable income is only about half of total personal income—which accounts in part for the high marginal rates that must be used today. When high marginal tax rates are applied to an emasculated definition of income, taxpayers are encouraged to channel part of their incomes into untaxed forms. This change in the composition or use of income reflects a loss in economic productivity as taxpayers devote resources to lower-valued uses simply because they are untaxed. Consider a person in a 50 marginal percent tax bracket. An additional $100 in taxable income is only worth $50 to him since the government collects $50 in taxes. If the taxpayer can transfer the $100 in taxable income to a nontaxed form, he will be better off even if the nontaxed use of $100 produces benefits worth only $51. In this case, the taxpayer benefits by $1 while the government loses $50 in revenue; $49 is effectively lost because the $100 in resources is devoted to a lower-valued use.

This type of waste, or efficiency loss, reflects a misallocation of resources caused by the existence of many untaxed sources and uses of income. A flat rate tax with a comprehensive measure of income would avoid this problem. In addition, even if some items continue to be given preferential treatment, the incentive for taxpayers to utilize these tax "loopholes" would be reduced due to the lower tax rate of the flat rate tax, so the efficiency losses of any remaining tax preferences would be lower.

Another benefit from the use of a more comprehensive tax base is that it would produce a fairer distribution of taxes among those with equal real incomes. Currently, taxpayers who are able to shift large portions of their incomes into untaxed forms pay less in taxes than those with equal incomes who are unable or unwilling to make as much use of tax preferences. The result is a wide dispersion in tax burdens among those who are equally well off. A flat rate tax with a

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broad measure of income would come closer to the ideal that "equals should be treated equally."

A final advantage that can be claimed for the flat rate tax is that it would be simpler. No one needs to be told that the present tax law is highly complex. Tax returns require a good deal of time to fill out correctly, and additional time is required to keep the necessary records. The time required to comply with the tax laws is a (socially) unproductive use of resources: if a taxpayer could pay the same final tax without spending 30 hours locating records and filling out forms, he would be better off and the government would receive the same tax payment. In the same sense, payments for professional tax assistance represent an efficiency loss. Today, nearly half of all taxpayers use professional tax preparers, up from 10 to 15 percent 30 years ago.

Complexity exacts another cost in addition to these outright resource costs: it makes the consequences of the income tax more difficult for the public to understand. Consider, for instance, the widely held view that wealthy taxpayers largely avoid paying taxes through ingenious and excessive use of tax loopholes, perhaps even to the extent of paying a smaller share of their incomes in taxes than middle income taxpayers. While the evidence shows this view to be untrue for the average high income person—only a tiny percentage of wealthy taxpayers accomplish this feat—it requires a fairly sophisticated knowledge of the present complex system to recognize how tax burdens are really distributed among income classes. A flat rate tax would not only be simpler to comply with, it would also be easier to understand the broader social consequences it produces.

These general advantages of a true flat rate tax are widely recognized, but against them must be balanced one overriding disadvantage: the distributional effects of the tax. To examine that aspect of the issue, we will rely on data from the Joint Committee on Taxation. In 1982, the Joint Committee on Taxation estimated that a flat rate tax of 11.8 percent would raise the same amount of revenue in 1984 as the present tax (assuming income levels were the same in 1984 as in 1981) if the tax base were expanded by eliminating all exemptions, deductions, and tax credits and all capital gains were taxed. While it would be possible to define an even more comprehensive tax base, we will examine this specific flat rate tax because of the availability of data concerning how it would affect various income classes.

Table 1 shows how the Joint Economic Committee estimates the distribution of tax burdens would be affected by substituting a flat rate tax of 11.8 percent for the federal income tax in 1984. (Incomes are expressed at 1981 levels; although incomes and tax revenues would be higher at today's price and income levels, the general

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TABLE 1

DISTRIBUTION OF TAX LIABILITIES:
FLAT RATE TAX VS. 1984 TAX LAW
(1981 Income Levels)

Expanded Income[a]	Number of Taxable Returns[b]	Tax Liability[c]		Change in Tax[d]
		1984 Law	Flat Rate Tax	
0–5	6.48	0.40	5.48	+783
5–10	15.06	5.77	14.28	+565
10–15	13.09	12.53	19.70	+548
15–20	10.74	17.46	22.50	+469
20–30	16.80	44.08	49.70	+335
30–50	13.57	63.83	60.58	−240
50–100	3.58	38.69	27.39	−3,156
100–200	0.63	18.66	9.87	−13,921
200 and up	0.16	16.39	7.68	−53,107
Total	80.11	217.80	217.17	−8[e]

[a]Thousands of dollars.
[b]In millions.
[c]In billions of dollars.
[d]Dollars per return.
[e]Average tax change.
SOURCE: Congressional Budget Office (1983, Table 7).

pattern of effects should be about the same.) Note that tax liabilities rise at expanded (that is, more comprehensively measured) income levels below $30,000 and fall at higher income levels.[2] In total, the 77 percent of taxpaying units with incomes below $30,000 are estimated to pay $31 billion more in taxes under the flat rate tax, while higher income taxpayers pay this much less. In 1981, $31 billion was about 1 percent of GNP and about 14 percent of income tax revenue. So the substitution of a flat rate tax for the present federal income tax can be expected to redistribute about 14 percent of the income tax burden from upper- to lower-income classes, a redistribution of about 1 percent of GNP.

[2]We are puzzled by the large increase in taxes per return shown for the under $5,000 class. If every family had income at the top of that class ($5,000), its total tax from an 11.8 percent levy would be $590, but the table shows an increase of $783.07. We suspect that this is due to the number of taxable returns in the table counting only those that are taxable under current law, while the number would be much larger under the flat rate tax. If so, the increase in tax liability per family would be less than shown for the lower income classes which contain significant numbers of nontaxable returns under current law.

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The redistributional consequences of a flat rate tax have led to its summary dismissal as a serious candidate for tax reform. Yet calculations of the sort appearing in Table 1 overstate the extent to which a flat rate tax would harm persons in lower income classes. These calculations are based on the assumption that each taxpaying unit's earnings would be the same under the flat rate tax as under the current tax, and therefore take no account of the beneficial effects of improved productive incentives of the flat rate tax. They also ignore the benefits of simplification and the broadened tax base. In short, Table 1 ignores all of the efficiency gains that are expected to result from a flat rate tax. Some of these gains will accrue to lower income classes, making the cost they bear less than is indicated in Table 1. Of course, the efficiency gains may offset only a trivial part of the cost on lower income classes. However, the analysis in the next two sections suggests that the efficiency gains of a flat rate tax significantly modify the picture of the distributional consequences suggested by Table 1.

Efficiency Gains: Labor Supply, Simplification, Broader Base

In this section, we will develop an estimate of the magnitude of the efficiency gain from a flat rate tax due to improved labor supply incentives, reduced compliance costs, and improved resource allocation from a more comprehensive tax base. In addition, we will allocate this aggregate gain among income classes. Making these estimates will require some heroic assumptions, but the economics literature does provide some guidance concerning the magnitudes we need to use. We caution, however, that this exercise does not purport to provide definitive conclusions; instead it is intended only to indicate the likely orders of magnitude involved.

We begin by considering the gains from increased labor supply under the flat rate tax. Two pieces of information are required to estimate how much labor supply will increase. First, we need to know how much marginal tax rates will fall under the flat rate tax since this determines how much after-tax rates of pay will rise. Second, we need to know how responsive workers are to an increase in the after-tax rate of pay. Our conclusion is that a flat rate tax will increase aggregate labor supply by about 5 percent. The reasoning that leads to this conclusion is fairly involved and occupies us for the next five paragraphs. For those readers willing to accept 5 percent as a reasonable figure, the next five paragraphs may be skipped. We should note at the outset that our estimate falls far short of the supply-side effects assumed by disciples of the Laffer curve. However, we

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believe it is a plausible estimate of the labor supply response to a flat rate tax that substantially reduces marginal tax rates.

In evaluating the effect on labor supply, it is important to distinguish between effective and statutory marginal tax rates. The statutory rates are simply those nominal rates in the law that identify the marginal rate that applies to changes in taxable earnings. The effective marginal tax rate measures the marginal tax relative to changes in total earnings, comprehensively measured. Changes in effective marginal tax rates are what affect labor supply, but unfortunately these changes are not easily measured.

To see the significance of the distinction between statutory and effective marginal tax rates, consider how a hypothetical taxpayer now in a 30 percent statutory marginal tax bracket is affected when his gross earnings rise by $100. Part of the $100 increase is likely to be received in nontaxable forms, such as fringe benefits, and part is likely to be devoted to outlays that are deductible, such as charitable contributions. Thus, taxable income may rise by only $70, and the 30 percent rate applied to this sum results in $21 in additional taxes. Relative to total incremental earnings, the effective marginal tax rate is only 21 percent, and we argue that it is the effective marginal rate that acts as an impediment to work incentives, not statutory rates. To see this, suppose that the statutory marginal rate is reduced to 21 percent at the same time that the tax base is broadened so that the entire incremental $100 is taxable. Nothing will have changed: if $100 more is earned, $21 in taxes will be paid and $79 retained. Although the statutory rate is lower, the *effective* rate is not, and there is no reason to expect work incentives to be improved. Only reductions in effective marginal tax rates will improve work incentives. While a flat rate tax will reduce effective marginal tax rates, it will reduce them less than the change in statutory rates suggests.

It is also important to recognize that it is the reduction in the combined effective marginal tax rate from all taxes affecting labor earnings, including the federal and state income taxes, social security, and sales and excise taxes, that is significant. Moreover, this rate varies among households. Ideally, we should consider the change for each household separately, but the detailed information necessary to do this is lacking. Instead, we will consider how the weighted average for the combined effective marginal tax rate of households will be affected. Based on other research, it is reasonable to take 44 percent as an economywide average value for the combined effective marginal tax rate.[3] According to a study by Barro and Sahasakul

[3]Browning and Johnson (1984, Table 3) have developed estimates of weighted average

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(1983), the weighted average marginal tax rate for the individual income tax alone was 29 percent in 1979 (which should be similar to 1984 levels). This may seem to suggest that a flat rate tax of 11.8 percent would reduce marginal rates on average by 17.2 percentage points. However, this estimate is larger than the reduction in the effective marginal rate: the Barro-Sahasakul estimate is for the average statutory marginal rate under current law, but the 11.8 percent rate would apply to a broader measure of earnings. So instead of assuming a 17.2 percentage point drop in the effective marginal tax rate, we assume the 11.8 percent rate only represents a reduction of 8 percentage points in the effective marginal tax rate. Although the precise value is largely conjecture on our part, we believe it is more accurate than simply assuming that the statutory reduction of 17.2 percentage points produces an identical reduction in effective marginal tax rates.

Thus, we assume that a flat rate tax of 11.8 percent applied to a comprehensive base will reduce the effective marginal tax rate from 44 percent to 36 percent on average. This assumption in turn implies that the after-tax rate of pay will rise from 56 percent of the before-tax rate of pay to 64 percent, a 14.3 percent rise. Next, we need to consider how much labor supply will increase as a result. The size of the adjustment in labor supply depends on how responsive workers are to changes in net wage rates at the margin. Labor supply elasticities, which estimate the percentage change in labor supply resulting from a given percentage change in the wage rate, have been studied extensively. Based on available evidence, an economywide average value for the labor supply elasticity of 0.3 seems reasonable.[4] This implies that labor supply would rise by 4.3 percent, a result that does not seem excessive given a 14.3 percent increase in the net rate of pay.

This calculation, however, understates the effect of the flat rate tax. Recall that the 11.8 percent rate is estimated to raise the same amount of revenue if actual incomes remain unchanged; if incomes rise, as

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marginal tax rates for each quintile of households in 1976. By weighting each of these rates by the share of labor earnings of each quintile we get an overall rate of 43 percent. Since both social security and income taxes are higher today, we think 44 percent is a reasonable figure to use, though it could easily be off by a few percentage points.

[4]We interpret the 0.3 figure as a compensated labor supply elasticity. Since the tax reform in question does not change the amount of tax revenue collected, there is no income effect for the community as a whole, and the compensated change in labor supply should equal the actual change. For references to the econometric literature dealing with labor supply elasticities, see Browning and Johnson (1984) and Stuart (1984).

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we have argued they would, a lower rate could be used and still raise the same revenue. Based on the assumptions described above, we estimate that a 10.0 percent tax rate would raise the same total revenue as an 11.8 tax rate with no increase in work effort.[5] Making these adjustments, the effective marginal tax rate would fall from 44 percent to 34.2 percent, and the after-tax rate of pay would rise by 17.5 percent. With a labor supply elasticity of 0.3, this implies labor supply would rise by 5.25 percent. This is our estimate of how much labor supply would rise under a flat rate tax applied to a comprehensive measure of income.

With such an increase in labor supply, labor earnings would rise by about $105 billion (at the 1981 levels used in Table 1). This increase does not represent a net gain to taxpayers, however, since they would be working more (consuming less leisure) to produce the additional $105 billion. The net gain is the extra earnings less the value of leisure given up. By using the after-tax rate of pay to value leisure, we estimate that the cost (in sacrificed leisure) of producing the extra $105 billion is $64 billion.[6] Therefore, we arrive at a net gain to taxpayers as a group of $41 billion from the improved work incentives of the flat rate tax.

There are two other efficiency gains that we can roughly estimate. First, there is the gain from tax simplification. Taxpayer compliance cost and the costs of collecting taxes would be lower under the flat rate tax. Slemrod and Sorum (1984) have recently estimated that the time cost of taxpayers complying with the current tax has a value of about 5 percent of tax revenue. In addition, the costs firms bear in administering withholding, costs of professional assistance, and collection costs of the Internal Revenue Service can conservatively be estimated at 2 percent of revenue. Therefore, total compliance and collection costs are probably about 7 percent of revenue, or $15 billion. We assume that the simpler flat rate tax would reduce these costs by one-third, or by $5 billion.

Second, there is the gain from the use of a more comprehensive tax base, which avoids the uneconomic shifting of resources to lower-valued uses because of tax advantages. The efficiency cost of these

[5]This 10.0 percent tax does not yield the same revenue as the present income tax. With additional labor earnings, tax revenues under social security, state income, and sales and excise taxes will rise, so an unchanged total government revenue implies less revenue from the income tax considered by itself. From a welfare standpoint, it is total revenue and not its distribution among separate taxes that is important.

[6]The after-tax rate of pay is initially 56 percent of the market rate and rises to 65.8 percent under the flat rate tax, so the average value of the after-tax rate of pay over the change in earnings is 60.9 percent. Multiplying this by the increase in earnings gives the value of leisure given up in earning the extra $105 billion.

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distortions under the present tax has been estimated to be about 7 percent of revenue (J. Browning 1979), or a total of $15 billion at 1981 levels. Since no feasible tax base is likely to eliminate all these distortions, we assume that a flat rate tax will result in a gain of $10 billion through improved resource allocation due to base-broadening.

Combining these three efficiency gains yields a total annual net gain of $56 billion. Again, we emphasize that this is only a rough estimate, but the assumptions on which it is based are entirely reasonable given the available evidence. This gain means that shifting to a flat rate tax of equal yield will increase the real income of the nation by $56 billion annually (at 1981 levels). Stated differently, the real burden of a flat rate tax that raises the same revenue as the present income tax would be about 20 percent less.

Recognizing these efficiency gains does not mean that everyone would benefit from the flat rate tax. The question of who would receive these gains is therefore of interest. We start with the changes in tax liabilities by income classes implied by the data in Table 1; the changes in tax liabilities are shown explicitly in the first column of Table 2. Recall that these changes are based on the assumption of an 11.8 percent tax rate applied to an unchanged level of earnings.

TABLE 2

DISTRIBUTIONAL EFFECT INCORPORATING SOME EFFICIENCY GAINS

Expanded Income[a]	Change in Tax Liability[b]	Efficiency Gains[b]		Change in Real Incomes[b]
		From Increased Labor Supply	From Simplification and Broader Base	
0–5	+5.08	1.03	0.03	−4.02
5–10	+8.51	2.70	0.40	−5.41
10–15	+7.17	3.72	0.86	−2.59
15–20	+5.03	4.25	1.20	.42
20–30	+5.62	9.38	3.04	6.80
30–50	−3.25	11.44	4.40	19.09
50–100	−11.30	5.17	2.66	19.13
100–200	−8.78	1.86	1.29	11.93
200 and up	−8.71	1.45	1.13	11.29
Total	−0.63	41.0	15.01	56.6

[a]In thousands of dollars.
[b]In billions of dollars.
SOURCE: Table 1 and calculations explained in text.

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Because of the increase in earnings under the flat rate tax, we have seen that a 10 percent tax rate can be used. Thus, even though all households may not increase labor supply to the same degree, all will benefit from the efficiency gain which permits use of a 10 percent rate rather than an 11.8 percent rate. (Note that a household whose income does not rise at all will benefit because its tax burden would be nearly 20 percent lower than estimated in Table 1.) Since all households benefit from a lower tax rate, we can allocate the efficiency gain from increased labor supply in proportion to tax liabilities calculated for the flat rate tax when no change in earnings is assumed. Column 2 in Table 2 shows the size of this efficiency gain when apportioned among income classes in this way.

The gains from improved simplicity and a broader tax base are allocated in a different way. These gains will likely accrue primarily to those who pay taxes under the present system, and are probably greater the more taxes currently paid. Therefore, the $15 billion efficiency gain from these sources is allocated in proportion to tax liabilities under the present income tax. The distribution of these gains by income class is shown in column 3 of Table 2.

The change in real net income for each income class is given by combining the change in tax liability as originally calculated in column 1 with the efficiency gains in columns 2 and 3; the results are displayed in column 4. Recall that Table 1 suggested that the lowest five income classes would suffer a loss of $31 billion from the substitution of the flat rate tax for the present income tax. The estimates in Table 2, however, imply that the combined loss of the lowest three income classes (the only ones that lose) is only $12 billion. Families with incomes above $15,000 are estimated to gain a total of $68 billion. Tax reform is not a zero sum game; the gains to those who are benefited are more than five times as large as the losses to those who are harmed.

This exercise shows that the adverse distributional consequences of a flat rate tax are likely to be substantially smaller than common estimates that ignore efficiency gains would imply. Moreover, there is one significant efficiency gain that we have not yet considered, namely, the gain from the increase in saving that a flat rate tax would produce.

The Efficiency Gain from Increased Saving

There are several reasons why the introduction of a flat rate tax can be expected to increase private saving. First, the redistribution of the tax burden in favor of upper income classes will increase total

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saving if upper income households tend to save more out of disposable income at the margin than lower income households. Second, lower effective marginal tax rates will tend to increase the after-tax return from saving, and more saving may be forthcoming when the return on saving increases. It is important, however, not to overstate the extent to which the after-tax rate of return will increase. Since much saving is already preferentially treated under the present income tax, moving to a flat rate tax might not increase after-tax returns for many taxpayers. Third, some portion of the increase in labor earnings that results from the improved work incentives will be saved.

In order to estimate the gain from increased saving, we require an estimate of how much saving will rise. Because saving is already preferentially treated and we do not know how much (if any) after-tax rates of return will increase under a flat rate tax, our estimate is based exclusively on the third source of increased saving mentioned above, that is, increases in saving resulting from increased labor earnings. In the last section, we estimated that disposable incomes would rise by $105 billion as a result of increased labor supply. Now we further assume that the marginal propensity to save is 0.15; thus, we estimate that saving will rise by $15.75 billion. This figure would represent about a 4 percent increase in the level of annual saving.

Why is an increase in saving a source of an efficiency gain? Under certain circumstances, it would be irrelevant to our analysis whether people spent or saved their increments in labor earnings. Specifically, if taxes on labor earnings are the only distortions in an otherwise competitive economy, there would be no efficiency gain. In this case, a person who saves an additional dollar receives the entire gain associated with providing funds that finance capital formation. If the real rate of interest is 5 percent, for example, an additional dollar saved would finance capital that (net of depreciation) will augment future production at an annual return of 5 percent. The saver, then, would receive the full increment in production that his saving makes possible. In this situation, if an increase in work effort raises income and leads to a dollar increase in saving, only the saver receives any benefit, and that benefit is correctly measured as one dollar.

The situation is different, however, when the government levies taxes on capital income. In the United States, several taxes fall on the return to capital, notably state and federal corporation income taxes, property taxes, and state and federal income taxes. The combined effect of these taxes is to make the rate of return received by the saver less than the rate of return actually generated when that saving finances capital investments. In a recent study, it was estimated that the before-tax real return to capital investments in the

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corporate sector was about 10 percent, but after taxes savers receive a real rate of return of about 3 percent (Feldstein, Poterba, and Dicks-Mireaux 1981). In other words, the effective tax rate on corporate capital is about 70 percent.

Consider what happens when a person saves an additional dollar, and the return on that dollar is taxed at a rate of 70 percent. To make matters simple, assume that the person will maintain the principal intact in the future and only consume the net return it provides. The saver then receives a stream of annual returns of 3 cents per year from a one dollar investment; that part of the gain from increased saving is received by the saver himself. At the same time, however, there is another gain that is not received by the saver, namely, the stream of annual capital tax payments of 7 cents per year that is also produced by one dollar in savings. People other than the saver himself will benefit because the increased future tax collections that his saving generates can finance lower tax rates and/or higher public expenditures. This part of the gain from increased saving was not taken into account in our previous estimates, and it represents a further increase in real incomes that result from the tax reform.

Now we turn to the estimation of the magnitude of the efficiency gain from increased saving. While the proper way to do this is a complex theoretical issue, we can easily explain why this gain is likely to be substantial by continuing with our previous example. The after-tax rate of return of 3 percent can be taken as a measure of how much people discount benefits received in the future: a benefit of $1.03 one year in the future has a present value of $1.00. When saving rises by one dollar, society in total receives a stream of annual benefits of $0.10 ($0.07 of which will go to the government and $0.03 of which goes to the saver). The present value of an infinite stream of annual benefits of $0.10, when the discount rate is 3 percent, is equal to $3.33 ($0.10/.03). Thus, when saving rises by $1, the present value of the future benefits is $3.33; one dollar of this is the present value of the benefit received by the saver and the remaining $2.33 is the present value of the future tax payments that the saving will generate.

What we have just illustrated with a simplified example is the calculation of what economists call the shadow price of capital. The shadow price of capital is intended to measure the present value of the future benefits that flow from an additional dollar of saving (and hence capital formation). Calculating a value for the shadow price of capital is more involved than in our example since the future effects of present saving also depend on how long the principal is held intact, the extent to which some of the annual net returns may them-

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selves be saved, and other factors. In a recent survey related to these matters, Lind (1982) concludes that 3.80 is a reasonable estimate of the magnitude of the shadow price of capital. We will rely on his estimate, and hope that our example makes the size of this figure plausible.

Coupled with our estimate that a flat rate tax will increase saving by $15.75 billion, a shadow price of capital of 3.80 implies that the present value of future benefits from that saving is $59.85 billion. (Note that this is the present value of benefits from one year's increase in saving.) Of this gain, savers themselves receive $15.75 billion—the present value of the after-tax returns received—and that amount is already included in our previous analysis as part of the increase in labor earnings. The remaining $44.1 billion represents an efficiency gain from the increased saving.

For our purposes, we also need to know how this gain will be distributed among income classes. It is not clear how best to proceed in this case, and we propose two alternatives. First, since the gain takes the form of higher future capital tax revenues, it would be possible to reduce the flat rate tax in future years and still generate the same tax revenue. This suggests allocating the gain in proportion to tax liabilities under the flat rate tax. Alternatively, the government might spend this additional revenue rather than reducing tax rates. Based on other research, it seems reasonable to assume that benefits from government spending are distributed equally among taxpaying units.[7]

Table 3 uses both approaches to allocate the efficiency gain from increased saving. The first column gives our previous estimates of the changes in real incomes by income classes (from Table 2). Columns 2 and 3 show the additional efficiency gains accruing to each income class when the aggregate gain is allocated in proportion to tax liabilities under the flat rate tax (column 2) and alternatively when it is allocated in proportion to the number of taxpaying units (column 3). The last two columns give the two alternative estimates of the total change in real income for each income class. These represent our final estimates of the distributional effects of substituting a flat rate tax for the present federal income tax. The results are striking. Instead of an aggregate loss of $31 billion to lower income classes, the lowest two income classes (the only two estimated to be harmed)

[7]In Browning and Johnson (1984), it is estimated that government transfers per household for each quintile in 1976 were $2,874, $3,317, $2,441, $2,117, and $2,485. These figures suggest to us that allocating the benefits of government spending to taxpaying units is not likely to be too far off.

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TABLE 3

DISTRIBUTIONAL EFFECT INCORPORATING ALL EFFICIENCY GAINS

Expanded Income[a]	Changes in Real Income Excluding Saving[b]	Efficiency Gains from Increased Saving Allocated to: Tax Liabilities[b]	Efficiency Gains from Increased Saving Allocated to: Taxpaying Units[b]	Change in Real Income Including Saving Allocated to: Tax Liabilities[b]	Change in Real Income Including Saving Allocated to: Taxpaying Units[b]
0–5	−4.02	1.11	6.60	−2.91	2.58
5–10	−5.41	2.90	7.67	−2.51	2.28
10–15	−2.59	4.00	6.67	1.41	4.08
15–20	0.42	4.57	5.47	4.99	5.89
20–30	6.80	10.09	8.56	16.89	15.36
30–50	19.09	12.30	6.91	31.39	26.00
50–100	19.13	5.56	1.82	24.69	20.59
100–200	11.93	2.00	0.32	13.93	12.25
200 and up	11.29	1.56	0.08	12.85	11.37
Total	56.6	44.1	44.1	100.7	100.7

[a]In thousands of dollars.
[b]In billions of dollars.
SOURCE: Table 2 and calculations explained in text.

lose only $5.4 billion when the gain from saving is allocated in proportion to taxes, while the higher income classes gain about $106 billion. When the gain from increased saving is allocated to taxpaying units, all income classes are estimated to benefit from the tax reform. In both cases, the aggregate efficiency gain is estimated to be in excess of $100 billion.

Evaluation of Distributional Effects

Our analysis has been based on the fact that if a flat rate tax leads to increased labor supply and/or saving, then lower income classes will receive some benefit even if their own labor supply and saving does not change. The reason, often overlooked, is that increases in earnings will generate additional tax revenue and permit either a tax rate reduction or an expenditure increase (or both), and in this way the efficiency gains from tax reform tend to be spread more widely through the income distribution. Our major finding is that the harm done to lower income households is substantially less than commonly supposed; indeed, they could actually benefit. While the exact

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values of our estimates should be viewed as merely suggestive, we believe they are based on plausible economic assumptions.

Before considering the significance of this finding, there are several additional aspects to the distributional issue that should be discussed. The first concerns the mobility of households within the income distribution. Figures like those in our three tables are based on the incomes households have in a single year. Often, however, a single year's income is not an accurate indication of the household's average economic position over a longer period of time. For example, suppose that a household in the lowest income class is there because of a temporary illness of the household head, and that in all other years that family has a higher income. In this situation, what really matters to the family's well-being is how the tax reform affects real tax burdens at the family's normal, higher income level. Calculations of the sort shown in our tables, which indicate how much taxes increase for the lowest income class, can be very misleading in situations like this.

From an equity standpoint, it is important to consider how the tax system affects households for longer than a single year. Unfortunately, what the distribution of income looks like over extended periods of time is not known exactly, but some recent estimates demonstrate that people shift around in the income distribution to a dramatic extent. For example, the Panel Study on Income Dynamics found that nearly half of families whose incomes placed them in the bottom 20 percent of the income distribution in 1971 were in higher income classes only seven years later (Lilla 1984, p. 70). The same study also found that only one-third of those counted as poor in a given year were poor in eight or more years out of a ten-year period. Even more interesting are the results of a computer simulation study of lifetime tax incidence in Canada by Davies, St.-Hillaire, and Whalley (1984, pp. 633–49). The Canadian study found that the poorest decile of households received only 1 percent of total national income in the annual data, but the lowest decile received 4 percent of total income when lifetime incomes were compared. To find that the lowest income class could have an average income over its lifetime that is four times as high as its income in each year's annual data is quite remarkable.

What data of this sort suggest is that it may be largely irrelevant how the tax system is estimated to affect people in the lowest one or two income classes shown in our tables: there may be very few households that remain in these classes when a longer-run viewpoint is adopted. Taking account of mobility, therefore, serves to strengthen our contention that low income groups will not be harmed as much

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as conventional analysis of annual data imply. Moreover, families that are not upwardly mobile can be helped with income transfers, as we will discuss below.

A second factor related to the significance of our estimates is the timing of the labor supply and saving consequences we have estimated. In our calculations, it was assumed that people would respond immediately to the lower marginal tax rate of the flat rate tax. In effect, we estimated the permanent, long-run effects of the tax reform. It takes time, however, for people to fully adjust to a major change in the tax structure, and the immediate, or short-run, effects will be quite different. For instance, two studies have estimated that it takes from two to four years for half the eventual change in labor supply to be realized. Moreover, the full effects of the increase in saving will be even more delayed; although we have expressed the benefits in present value terms, the effect of increased saving on augmenting capital income tax revenues would be quite small in the beginning and perhaps take 20 to 25 years to grow to its full magnitude.

In the short run, that is, the period immediately following the tax reform, labor supply and saving would probably not increase significantly. Consequently, the short-run, albeit temporary, effect of the tax reform on the distribution of income might look more like Table 1 than the other tables. In other words, the immediate consequences would involve substantial costs on low income households. Although these costs would diminish over time and for many households actually become benefits after a few years, there is no avoiding the fact that present costs must be borne for a time before future benefits will be realized.

Because the short-run effects of a movement to a flat rate tax differ in this way from its long-run effects, tax reform of this nature is likely to be difficult. Politicians are widely thought to take a short-run viewpoint in evaluating public policies, and that viewpoint naturally leads to an emphasis on the "massive redistribution" of tax burdens that a flat rate tax would produce. It would be unfortunate if such a perspective is the basis for rejecting a tax reform that holds out the promise of benefiting most people. Such an outcome is, however, understandable.

It is probably true that a concern for the well-being of low income households accounts for the lack of serious attention given a true flat rate tax. It is simply taken for granted that the income tax must exempt the neediest households from taxation. There are other ways, however, to assist the needy that should also be considered. For example, government transfer programs can also serve this function. In fact, transfer programs are far more important to the well-being of low

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income households than is the federal income tax. Even if a flat rate tax were used, government transfers to the poorest 20 percent of households would still be three times as great as the total (federal, state, and local) tax burden on these households. What this fact should make clear is that our redistributional goals are now being served primarily through our system of transfers instead of by the progressive nature of the income tax. Moreover, this is as it should be. Through transfer programs, we can better target assistance on the neediest households than we can by manipulating the tax law. (Cutting taxes for low-income people and raising taxes for high income people, for example, does little to help the neediest families if they have little or no taxable income. Increasing transfer payments, however, can help.)

What is not adequately appreciated is that the existence of a well-developed (if not well-designed) system of transfers greatly reduces our need to rely on the income tax as a redistributive device. It is simply not necessary for every government policy to serve a redistributive goal since transfers can be adjusted so that the net effect of the system as a whole is to help the poor. For example, it would be possible to couple enactment of a flat rate tax with a moderate (and perhaps temporary) increase in transfers to the poor, thereby mitigating or avoiding harming the truly needy while at the same time realizing the efficiency advantages of the flat rate tax. While we do not necessarily advocate this approach (since it could easily be abused), we only suggest it to show that the cost the tax reform considered by itself would impose on the poor is not a sufficient reason to dismiss it.

Modified Flat Tax Proposals

All of the proposals for tax reform that are receiving serious attention are modified flat tax proposals. These proposals are quite different from what we have described as a true flat rate tax. Specifically, there are two important differences. First, the tax base is defined in a way that continues to exempt large amounts of income so that taxable income continues to fall far short of the total income of taxpayers. Second, instead of a single rate applied to this base, a set of graduated rates is used. Generally, however, the number of separate marginal rate brackets is lower than under the present tax.

Perhaps the most important of the tax proposals are the Bradley-Gephardt bill, the Kemp-Kasten bill, and the recent Treasury Department proposal (Treasury I). All three of the proposals would selectively eliminate cetain tax preferences, although there are differences

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in exactly which preferences would be abolished. All three would increase personal exemptions, thereby expanding one important tax preference, and all three would reduce the number of separate marginal rate brackets effectively to three. Under Bradley-Gephardt, the marginal brackets are 14 percent, 26 percent, and 30 percent; under Kemp-Kasten, they are 20 percent, 28 percent, and 25 percent[8]; under Treasury I, they are 15 percent, 25 percent, and 35 percent.

We have argued that the efficiency gains of a true flat rate tax would probably be substantial. The natural question to consider now is how the modified flat tax proposals compare to the true flat rate tax in this regard. Supporters of these measures claim that their lower marginal rates—although not as low as could be achieved under a true flat rate tax—would increase incentives to work, save, and invest. However, we contend that none of these proposals would lead to any significant improvement in productive incentives.

To demonstrate this, it is not necessary to engage in any sophisticated theorizing. Instead, we need only accept the claims of the sponsors of these proposals that they would not effect any significant change in tax liabilities by income class. If the actual degree of progressivity of the present tax system is retained, it immediately implies that *effective* marginal tax rates have not been reduced at all. This is simply a matter of arithmetic. If the present and new tax liability is $3,000 at an income of $30,000, for example, and both taxes impose a liability of $5,000 at an income of $40,000 (the assumed unchanged degree of progressivity), then the effective marginal tax rate applied when income increases from $30,000 to $40,000 must be 20 percent under both taxes since the additional tax liability is $2,000. Similar reasoning applies for other income classes. It makes no difference whether the statutory marginal tax rates are lower; if they are applied to a broadened measure of income at the margin, as they must be if actual tax liabilities are to remain unchanged, then the effective marginal tax rates will not be any lower. And incentives will improve only if effective marginal tax rates are reduced.

We are not arguing that these proposals will not improve any single person's incentive to earn, but just that on average there will be no improvement. Some people may face lower effective marginal tax rates, but others in the same tax brackets must be facing higher

[8]The Kemp-Kasten plan has a nominal marginal tax rate of 25 percent that applies to all taxable income. However, it also utilizes an earned income exclusion of 20 percent of earnings that applies up to $40,000, and that makes the net marginal tax rate equal to 20 percent up to that level of income. The exclusion is gradually phased out at earnings between $40,000 and $100,000 in a way that makes the net marginal tax rate 28 percent over this range. For incomes over $100,000, only the 25 percent rate applies.

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effective marginal rates if the tax liabilities by income class really do remain largely unaffected. For example, last year *Newsweek* (1984) published a comparison of average tax liabilities by income class under Bradley-Gephardt and the present tax. There was, in fact, very little difference in the average tax liabilities for each income class; Bradley-Gephardt produced slightly lower taxes on households with incomes under $25,000 and slightly higher taxes on those with higher incomes. This implies that the additional taxes paid if a taxpayer moves from a lower to a higher bracket will be greater under Bradley-Gephardt: how could this possibly give one more incentive to earn more under Bradley-Gephardt?

What the modified flat tax proposals do is to produce lower statutory marginal tax brackets by broadening the tax base in a way that does not produce the lower effective marginal tax rates on which incentive effects depend. An example may help to make this clear. Suppose a person is now in a 40 percent tax bracket; then the marginal tax is reduced to 36 percent at the same time the tax base is broadened by disallowing the deduction of state income taxes. Does this person have any greater incentive to earn income? If he is in a 10 percent state tax bracket, the answer is no. Suppose the person under current law earns $100 more. Ten dollars is paid to the state and 40 percent of the $90 taxable income under the federal tax ($100 less the $10 deduction), or $36, is paid to the federal government. He keeps $54 out of the $100; his effective marginal tax rate is 46 percent. Under the alternative tax, the $10 deduction is not allowed, and the lower statutory rate of 36 percent applies to the full $100, so the federal tax liability is still $36 and the state liability is still $10. He still gets to keep only $54 out of the extra $100 earned; his effective marginal tax rate is still 46 percent even though the statutory rate of the federal tax has been reduced from 40 percent to 36 percent.

Insofar as these modified flat tax proposals really do not significantly change actual tax liabilities at each income level, they must do so in a way analogous to the example above. They produce illusory lower marginal tax rates by applying these rates to a larger part of each additional dollar of earnings than the present law. Consequently, it is difficult to see how they can be expected to improve incentives to earn income.

The modified flat tax proposals, therefore, cannot be expected to produce the increases in labor supply and saving that a true flat rate tax can. This is not the same as saying that they are undesirable, but only that the efficiency gains will be less than under the tax reform we evaluated earlier in this paper. To indicate the significance of this, we estimated a total efficiency gain for a flat rate tax of $100

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billion annually, of which $41 billion was due to increased labor supply and $44 billion to increased saving; a modified flat tax would realize none of these gains because saving and work effort would be unaffected. The remaining $15 billion gain we estimated for a true flat rate tax was due to improved resource allocation from a broadened tax base and to the greater simplicity of the tax. Since the modified flat tax proposals broaden the tax base by less than a true flat rate tax and simplify the tax less, they will produce only a fraction of the $15 billion in efficiency gains. Overall, the efficiency advantages of the modified flat tax proposals can realistically be expected to be only a small fraction of the gains that could be expected from a true flat rate tax.

Modified flat tax proposals are predicated on the assumption that it is politically infeasible, or for some other reason undesirable, to substantially change the distribution of tax burdens by income class. Accepting that as a constraint, however, is equivalent to forgoing much of the sizable efficiency gain that is possible from a true flat rate tax.

Conclusion

Why not a true flat rate tax on total earnings in place of the present complex, inequitable, and inefficient income tax? As we have seen, the advantages are substantial. The major objection that has forestalled debate on this type of tax reform has been that it will impose huge costs on middle- and low-income households. We have argued that the efficiency gains are sizable enough to offset a large part of these costs. Moreover, once it is recognized that transfer programs are a better way to insure adequate income for the truly impoverished, the possibility of a meaningful improvement in our tax system becomes real. We can have a simpler, more easily understood, more equitable, and more efficient tax system.

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LINGERING QUESTIONS ABOUT TAX REFORM

Pamela P. Peterson

The debate over tax reform includes the proponents of a flat rate tax system, although the term "flat tax" has been used to describe many rate structures. In their paper, Browning and Browning (1985) favor a single-rate flat tax. They note, quite correctly, that many of the so-called flat tax schemes introduced in recent years are really modified flat rate taxes. Supporters of these modified flat rate systems reject a true flat rate tax because of their concern over the distributional problems associated with the shift to a single rate system. The Brownings' paper, however, demonstrates that a true flat rate will not injure lower income households to the degree conjectured in other studies. In fact, a true flat tax may benefit lower income households in the long run. The major reasoning behind this position is that efficiency gains from tax simplification and a single rate system may exceed any increase in the tax burden for lower income households.

Advantages of a Flat Rate Tax

The authors cite four advantages to be gained by moving to a true flat rate tax system. One advantage is that a reduction in marginal tax rates may improve the incentives to produce. The example provided, however, assumes that a person who has an opportunity to earn additional income will not seek out tax avoidance for all or part of any additional income. If individuals do seek out this avoidance, then the reduction of marginal tax rates may not significantly affect the willingness to produce, assuming that methods of avoidance are available.

Another advantage of a flat rate system, which rests on a more comprehensive definition of income, is that the marginal tax rate could be reduced. The authors estimate that the expansion of the

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definition of taxable income can lower the marginal tax rate to the range of 10–12 percent. Aside from the lower marginal tax rate, the base broadening may encourage the reallocation of resources from less productive uses (currently subject to preferential tax treatment) to more productive uses. This shifting of resources may then provide gains to the economy, correcting the misallocation of resources encouraged under the present tax system.

A further advantage of the flat rate tax system is the more equitable distribution of tax burdens among the "informed" and the "uninformed" taxpayers. While the present tax code is complex and the attendant regulations and cases provide opportunities for tax avoidance, it is not clear from empirical evidence that taxpayers do in fact utilize the avoidance provisions to their advantage. For whatever reason underlying the less aggressive tax positioning of taxpayers, the disparity in tax burdens among informed and uninformed taxpayers in equivalent financial situations may not be wide.

Another advantage of moving to a true flat tax system would be the reduction in the compliance burdens of the taxpayers and the enforcement burdens of the tax collector. While the Tax Reform Act of 1976 may be referred to as the "Accountants' Right to Work Act," the simplifying tax reform may be referred to as the "Accountants' Unemployment Act." The changeover to a simpler tax system may provide accountants and lawyers with a short-term burst of business due to the restructuring of taxpayers' investment portfolios, but the long-term effect would be to reduce the demand for these services.

A disadvantage of a single flat tax cited by proponents of modified flat tax plans is the distributional effects of any gains from simplification and broadening the income definition. As the authors point out, these gains may accrue to lower income classes. However, the effect of any gains on the tax burdens of lower income classes requires conjectures as to the magnitude and distribution of the gains. Termed "heroic" assumptions by the authors (and in fact the qualifier "very" may be added to "heroic") these assumptions directly determine the conclusions regarding distributions of tax burdens. The assumptions and their effect on the distribution of the tax burden are examined carefully by the authors.

Labor Supply, Simplification, and a Broader Base

The efficiency gains generated from changes in the labor supply are derived from the reduction in marginal tax rates; it is assumed that marginal tax rates are primary determinants of labor supply decisions. As the authors point out, reducing *statutory* tax rates is

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not sufficient to stimulate labor supply unless *effective* marginal tax rates on labor income fall, because the tax base may be broadened.

Efficiency gains are also realized from moving to a more comprehensive tax base, say the authors, because resources will shift from less to more productive uses. The authors assume that it is possible to eliminate tax loopholes—avoidance measures that are unintentional in the design of the tax law and that favor unproductive uses of capital. Tax loopholes are analogous to the proverbial leaking dike—as one leak is plugged, another leak appears. It is questionable, however, whether these leaks can be stopped even under a flat rate tax, given the political nature of tax legislation and the complexity of our financial system.

The authors also discuss the benefits of tax simplification, namely, lower compliance costs and a more efficient tax collection system. While it is quite easy to see that there may be gains from shifting resources away from these tasks, the authors do not consider the loss of benefits (though perhaps small) attributable to the annual examination of taxpayers' financial positions and personal financial planning which is required under the present system.

Increased Savings under the Flat Tax

The authors argue that further efficiency gains are generated from the increased savings they expect to occur under a true flat rate tax. They indicate that the lowering of the marginal tax rate on earnings from savings may encourage savings. This is true, however, only if the returns from savings are taxed more heavily under the present system. In fact, many forms of savings are (essentially) not taxed under the present tax system (for example, earnings from IRAs and KEOGH plans); thus, if these preferential features are removed in the tax simplification process, there may be a revenue loss. The authors also assume that a portion of the increase in labor earnings will be saved, but the question of consumption versus savings of the benefits from reductions of tax burdens is still an unresolved question.

Distributional Effects

The authors estimate the benefits derived from the various sources by relying on empirical evidence from other studies. The net effect of a flat rate tax system is estimated to be approximately $100 billion, where the difference between the analysis provided in other studies of the flat rate tax and this study lie in the inclusion of benefits from labor supply changes, simplification, base broadening, and increased savings.

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Aside from the problem of estimating the gross benefits from these changes, the authors are required to make heroic assumptions regarding how these benefits are distributed among income classes. Since the authors' primary purpose is to demonstrate the distributional effects of a tax change, the assumptions underlying the distribution of these benefits are very important. Much of the benefit from the shift to a single rate system is derived from the behavior of the economic agent, the taxpayer. That is, given the changes in the marginal tax rate, the definition of income, and the tax avoidance provisions, how does the taxpayer alter his decisions affecting work effort, savings, and investment? Although it is not possible to say a priori what the actions of taxpayers will be, conclusions regarding the distribution of benefits must be examined for their sensitivity to the distributional assumptions—a consideration that is noticeably absent from the present study.

Additional Considerations for Tax Reform

There are several other factors that should be considered in evaluating any tax reform proposal. First, the costs and benefits associated with a tax change or "overhaul" must be considered. When changes are made in a tax system that require a reallocation of capital and labor, and that alter savings incentives, there will be some costs associated with this transition. Moreover, while many of the benefits described in the present study and other studies are benefits expected during future time periods, the costs of transition are in today's dollars, not future dollars. A complete analysis of the effects of tax changes must therefore consider the present value of the benefits (discounted at a rate that considers the uncertainty of generated benefits) and the present value of costs of transition (which most likely will be concentrated in today's dollars). A study that ignores these costs and fails to consider the timing of the benefits to be received in the future is incomplete.

Further consideration must be given also to whether the proposed tax system is a "good" tax system—defined as one that is equitable, certain, convenient, and economical. The authors establish the present tax system as the benchmark for their analysis of the distributional benefits from switching to a flat rate tax system (Table I). However, two questions need to be raised before embarking on this analysis: First, is the present system equitable? Second, is the tax burden after the flat tax equitable? These questions are not addressed in the Brownings' study. To show that tax burdens are altered does not demonstrate that a system is equitable. Further, if "equitable" is

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defined in terms of the wherewithal to pay, does not the expanded income definition risk violating the ability to pay principle?

Another feature of a "good" tax system is the certainty of the system. A dramatic changeover in the tax system—such as under the proposed flat rate tax—demands changes in taxpayer planning, which may be viewed as a violation of the certainty feature. Finally, in a system where tax policy is controlled by a political body, will a flat rate tax be immune to the tinkering of politicians responding to special interest groups?

After a change to a flat tax system, there most likely will be greater convenience and a more economical collection of taxes. However, these features are a function of a simplification of the system, rather than of the rate structure.

The main focus of the Brownings' paper is on the shifting of the tax burden among income classes. Before a tax system is proposed, however, the objective of the tax system must be clarified. Is the objective of the tax system to produce revenue for the federal government? Is the objective of the tax system to enact social policies (for example, welfare)? Is the objective of the tax system to carry out specific economic policies (for example, to increase savings and investment)? If the purpose of the tax system is to produce revenue, then the focus of tax policy should be on the most efficient method of collecting taxes; if certain social and economic goals are to be simultaneously achieved, then other vehicles to carry out policy must be employed. If, on the other hand, the objective of tax policy is to achieve certain social goals, then the optimal distribution of the tax burden should be agreed on beforehand. The tax structure that achieves the desired social goals can then be designed. Again, if the goal of the tax system is to stimulate labor effort, the labor effort goal should be examined and the tax system should be selected to achieve this goal, for a given revenue target. In other words, the evaluation of a tax proposal, whether it be a true flat tax, a modified flat tax, or a progressive tax, must be consistent with the objectives of tax policy. Comparing tax burden distributions, as the Brownings do in Tables 1, 2, and 3, does not address the more important question of whether a given distribution of tax burdens is desirable.

In closing, a few minor points need to be brought up. First, the authors fail to mention how the true flat rate system is to operate alongside a corporate tax system. Since there are several aspects of an individual's economic decisions that may be affected by the taxation of business enterprises, the analysis of benefits derived from a true flat tax must consider the effects of taxing business enterprises. Second, the authors do not mention the losses that may result when

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current investment incentives are removed. The expanded income definition and the alteration of savings and investment income taxation may reduce incentives to invest, adversely affecting total investment. Third, in their criticisms of the modified flat tax proposals, the authors fail to recognize that these tax changes may generate benefits through tax simplification and base broadening. Thus, although the Brownings offer an interesting analysis of the flat rate tax, there are still many questions that deserve further study.

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COMMUNICATIONS

ABOLISHING THE POSTAL MONOPOLY: A COMMENT

Douglas K. Adie

First class postage rates have been raised once again in an effort to curb the Postal Service's financial problems. This scenario, which has taken place regularly every two or three years, has resulted in first class rates rising faster than inflation. In most industries, an "easy" solution of this kind is not possible because businesses must compete to survive. But then, as Miller (1985) emphasizes, the Postal Service is facilitated by a monopoly on first class mail. Where did the monopoly come from in the first place? Should the Postal Service be allowed to keep avoiding the realities of the marketplace?

My view of the beginning of the postal monopoly is pragmatic, as is Miller's, but I also view the growth of this public monopoly as cyclical rather than constant. Miller says that the Constitution gives only Congress the right to conduct postal business. Furthermore, he says the Postal Service took on itself the responsibility for defining a "letter" and thereby cinched its own monopoly. I believe the Post Office felt the need to do so historically because there has always been a sizable contingent which did not respect the monopoly provision, especially if service was poor and rates high. Periodic challenges have taken place, often under the benign neglect of the government if not its official sanction. The historical record suggests that

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The author is Professor of Economics at Ohio University. This comment was prepared as part of a larger research project examining the U.S. postal monopoly, which is being funded by the Cato Institute and the George F. Bennett Chair in Economics and Business at Wheaton College. Lori L. Oeffner, Stephen C. Folkerts, and James L. Rogers assisted in the preparation of this paper; the author alone is responsible for its content.

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the freedom to communicate efficiently has been regarded as more important by Congress than the government's monopoly.

Miller asks, "Is the postal monopoly justified?" He answers that the standard economic justification is that the Postal Service production process satisfies certain technical conditions termed "increasing returns to scale" so that its average costs decline with volume. This should enable it to provide mail service on an exclusive basis cheaper than any other combination of firms. Miller doubts that the econometric evidence shows that the Postal Service is a "natural monopoly" and notes that if it were, it should be able to produce postal services at the lowest possible cost. Therefore, it would not need the protection of legislation. This is a good argument.

In fact, the Postal Service assumes that it is an efficient "natural monopoly" but nevertheless complains about creamskimmers. This is ludicrous. Its price not only exceeds its average cost for first class mail but it actually exceeds the costs of beginning entrants operating at low volume. Under the "natural monopoly" assumption, the average cost of these new entrants—because they operate at low volume—should be much higher than the average cost of the monopolist. The Postal Service is caught on the horns of a dilemma: either the Postal Service is not much of a "natural monopolist" or it is in violation of the terms of reorganization because its price is above its average cost. If we note that a Minnesota firm delivers third-class mail, which is already a low-rate mail, in rural areas at a price below that charged by the Postal Service and still earns a profit, it is not difficult to conclude that the Postal Service is extremely inefficient.

Parenthetically it does little good to use the relatively modern concept of "natural monopoly" first coined by Henry C. Adams around 1910, to justify a government monopoly that dates back almost to the founding of this country. Underscoring this point even more, the concept of "natural monopoly" is today being discredited by economists (see Hazlett 1985).

From my work I have found that technically the Postal Service produces under "increasing returns to scale," or "decreasing average costs."[1] These estimates of the coefficients of the production and cost

[1]Using a weighted measure of total mail volume Q for all classes of mail and the Cobb-Douglas production function, I have estimated the parameters of the production function for the Postal Service as follows:

$$Q = 4.81\, L^{1.46}\, K^{0.09} \qquad \text{adj. } R^2 = 56.1\%$$
$$(0.908)\quad (0.224)\quad (0.059)$$

where L and K are quantities of labor and capital. The standard errors are in parentheses. The sum of the exponents of L and K is 1.55, which indicates increasing returns to

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functions, however, are *irrelevant* for a business which is not forced by competitive incentives to be efficient. Indeed gross inefficiencies in management and production render estimates of the coefficients useless for determining economies of scale or the nature of costs. In a government-owned enterprise not subject to competitive pressures or the profit motive, resources are not utilized efficiently nor are costs minimized, thereby violating an important assumption for estimating coefficients of production and cost functions from regression analysis.

The X-efficiency literature (the classic article being Leibenstein 1966), which I believe is applicable to this case, suggests that competition in all postal activities would lead to lower costs because it would improve the incentives to operate efficiently. In short, the inefficiency of a government monopoly such as the Postal Service is so large that it offsets any economies of scale that otherwise might be enjoyed.

But back to the question of the original justification for the government monopoly. Government ownership cannot really be separated from the postal monopoly as Miller tries to do. The Post Office was a government enterprise because the government wished to use it to aid economic development. This was to be done by performing numerous activities in the so-called public interest through the Post Office because private enterprise would not undertake them voluntarily. These public-service chores were designed to bind the nation together with universal communication service at uniform rates, especially in rural areas. Specifically the plan was as follows. It was first decided that certain public services needed to be supplied by the government. To do this, a government-run Post Office was instituted. Because these public services demanded funding over and above the revenues normally commanded by a delivery service, a machinery for raising additional funds was needed. Subsidies from the public treasury could be used as a last resort, but it was thought that it would be more desirable for the Post Office to be substantially self-funding. In effect, a monopoly on first class mail was instituted

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scale, a technical characteristic of a natural monopoly. My estimate of the parameters of the total cost function is as follows:

$$C = 5.87\ Q^{0.606} \qquad \text{adj. } R^2 = 21.7\%$$
$$(1.383)\ \ (0.156)$$

where C = total costs. The exponent of Q is 0.606, which indicates that the average cost function declines with increasing quantity, another technical characteristic of a natural monopoly. Further details will appear in my forthcoming monograph on deregulating the Postal Service, which is being published by the Cato Institute.

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to allow the Post Office a competitive advantage that would assure that sufficient revenues were generated.

At this present point in history, however, the original reasoning evaporates. The present-day situation is such that the completion of the original public service tasks, as well as the changing communications technology, have reduced the postal mission to a daily delivery chore. It is unlikely that the Postal Service would still be a monopoly if it were not owned by the government. Why should the government rather than the private sector now deliver the mail? The burden of proof for the postal monopoly, as Miller correctly states, now lies on the government just as it did in the beginning.

Miller correctly notes that the actual costs of the postal monopoly are difficult to measure because they apply primarily to first-class mail while the Postal Service delivers four classes of mail and is either unable or unwilling to allocate costs adequately to all types of mail. The discrepancy between the Postal Service's actual costs and what they could be if they operated efficiently are also difficult to measure for lack of data, but it is suspected by many that this discrepancy may be very large (in excess of 50 percent).

The lack of incentives reduces efficiency which in turn leads to a failure to hold down wages, innovate successfully, and utilize labor efficiently. How has the Postal Service been able to cover up its excessive costs (approximately $14 billion per year)? Bakers cover their mistakes with whipped cream; doctors bury theirs; the Postal Service raises first-class postage rates.

The solution proposed by Miller to the chronic financial difficulties in the Postal Service is to repeal the private express statutes and thereby end the postal monopoly. This is a sensible and timely idea. Miller's solutions will restore efficiency to the mail delivery service.

One fear of this policy solution, mentioned frequently in congressional hearings and addressed by Miller, is that rural residents will lose service or be faced with higher rates. Miller tries to allay the fears of rural residents by pointing to the experience in airline deregulation. Miller shows concern for rural mailers by suggesting that, should there be a significant diminution in rural postal services as a result of deregulation, a subsidy program for rural delivery could be implemented. This would be similar to the program that supports rural air service. The costs of this subsidy are estimated at $26 million per year, a small price to pay for such an appealing remedy.

What, however, will become of the Postal Service and its 700,000 employees? Without further changes in the Postal Service, I doubt it could survive repeal of the private express statutes. By itself this action, I predict, will speed up the demise of the Postal Service and

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possibly put a greater strain on the public treasury. Is there a way of launching the Postal Service that will increase its chances for survival? I think so. Repeal of the private express statutes, accompanied by other deregulatory measures, needs to be coupled with divestiture and privatization. Privatization will remove taxpayer liability from the Postal Service's mismanagement and also provide the incentive for the Postal Service to succeed. Divestiture will open up the postal industry to competition at many levels and divide the Postal Service into several smaller companies which would be more easily managed and provide more opportunities for different forms of innovation. Deregulation, the most important part of which is repeal of the private express statutes, will free the Postal Service to compete in any line of business it wants to enter on an equal footing with other private businesses, and also remove from the Postal Service other special government granted privileges.

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BOOK REVIEWS

Privatizing Federal Spending:
A Strategy to Reduce the Deficit
Stuart M. Butler
New York: Universe Books, 1985, 186 pp.

There is no shortage of fervent tracts and ideological treatises on the virtues of privatization, but there is not yet an abundance of intellectually respectable writing that goes into detail, provides compelling support for the concept, and persuades by reason rather than by rhetoric. Stuart Butler, the person who was the transatlantic carrier of enterprise zones, helps redress the balance in his latest book. This is a carefully reasoned, nonpolemical, well-written, and highly readable book whose title clearly defines and delimits the book's contents.

The book begins with an analysis of the Reagan administration's effort to reduce spending by cutting Congress's allowance, that is, by denying Congress the taxes to spend or to squander. This is referred to as a supply-side approach—reducing the supply of available funds. This tack has been notably unsuccessful, as evidenced by the growth of federal spending as a percentage of the Gross National Product. The reason for the failure—by this measure—is that the demand for federal programs has not been checked, and continues to be fed by the powerful coalitions that spring up behind each program, coalitions comprised of bureaucrats, beneficiaries, service suppliers, political activists, and legislators. Legislators learned long ago that it is perfectly legal to buy votes, as long as public funds are used; it is illegal only if private funds are employed for the purpose. Butler reviews the process, identifies the roles and behavior of the participants, and analyzes the reasons why government programs grow. The ratchet effect assures that spending moves only one way, up—a recent French book that is part of the growing international movement toward less government is titled *Toujours Plus (Always More).*

Madsen Pirie, author of *Dismantling the State,* recounts the experience in England when an attempt was made to close the frightfully expensive and no longer necessary public bath-houses, a vestigial remnant of the Victorian era. The handful of users chained themselves to the doors, but no taxpayer in his right mind would demonstrate as forcefully

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for their closure. As a result the bath-houses were kept in the budget. That is what happens when the benefits are concentrated and the costs are dispersed. And that is what happens when the goods being dispensed are private goods rather than collective goods; private goods benefit individual recipients directly and therefore are subject to this kind of perversion. Collective goods, whose provision unquestionably requires a collective—often governmental—effort (for example, a big-city fire department), generally lack such devoted supporters because relatively few people are direct beneficiaries. There are many indirect beneficiaries, however, such as purveyors of supplies, local merchants in the vicinity of a firehouse, and so on.

Butler includes interesting discussions on the privatization of federal properties, such as public housing, public lands, and Amtrak. The Reagan administration has opposed more construction of assisted housing and instead adopted the voucher system—one of the most promising approaches to privatization. But what can be done about existing public housing? In Britain, the Thatcher government succeeded in selling off almost a tenth of the public housing and its program could serve as a model for the United States. The circumstances are sufficiently different, however, to require a special effort. Public-housing tenants in England (a third of the population) have a median income very close to the national median, whereas in the United States public-housing tenants have much lower incomes than the median. Moreover much of the public housing in England consists of one-family units; in the United States relatively more is in multifamily structures. Altogether then, in the United States there are more impediments to selling off the public-housing stock to current tenants. Butler therefore advocates tenant-management cooperatives as an interim arrangement before granting tenants the right to buy.

In addition to the question of privatizing federal properties, Butler also addresses the question of privatizing federal services. Human services, including social security, constitute such a large portion of the federal budget that no discussion of deficit reduction would be complete without treating this thorny area. Greater reliance on "mediating structures" in the private sector—such as families, churches, and neighborhood groups—is the key to better performance of most social and welfare programs, while reform of the social security system should follow the carefully wrought recommendations of Peter Ferrara. These can be summarized briefly as separation of the welfare function from the retirement income function, and for the latter, reliance on mandatory contributions to individual retirement accounts (IRAs) rather than reliance on a government-sponsored Ponzi scheme.

Other federal services Butler examines are the postal service (an inviting target), commercial space transportation, air-traffic control, and defense procurement. Butler does not flinch in castigating major defense contractors who, while technically within the private sector, are virtually indistinguishable from government bureaus. Locked in an embrace with

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procurement officials, the firms do not operate in a truly competitive environment. Butler calls for more competitive procurement practices, greater competition among services within the Pentagon bureaucracy, and, above all, an independent testing office in the Department of Defense to evaluate and perform acceptance tests on weapons systems that are being developed and delivered; this is in distinction to a system where the unit that wants a weapon decides whether what they got from the contractor is good enough.

The greatest original contribution of this book is its continual emphasis on building political coalitions to implement privatization and to ensure its permanence. Instead of merely serving as yet another eloquent plea for privatization, the book carefully identifies potential beneficiaries of privatization and suggests ways for them to coalesce into counter-constituencies that can overcome the coalitions for government spending and can change the status quo. Butler offers the following 10 techniques for privatizing federal spending: (1) Challenging the classification of goods, that is, adhering rigorously to the scheme proposed by Savas,[1] and selecting suitable market segments for privatization; (2) pressing for programs to be administered and financed closer to the end user; (3) linking specific taxes to specific spending in order to establish a clearer relation between costs and benefits; (4) applying user charges wherever possible to further strengthen the recognition that benefits have costs; (5) "buying out" key members of the spending coalition; (6) using research and public relations effectively; (7) deregulating government monpolies and introducing competition; (8) providing tax incentives that promote privatization; (9) strengthening privatization coalitions by fostering and organizing suitable networks; (10) employing incremental rather than revolutionary tactics.

Butler has a thorough understanding of the policy making process. His privatization proposals are well reasoned and innovative. As such his book makes a significant contribution to the privatization literature.

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Blueprints for Basic Tax Reform, 2d ed.
David F. Bradford and the U.S.
Treasury Tax Policy Staff
Arlington, Va.: Tax Analysts, 1984, 194 pp.

The publication of a revised second edition of *Blueprints* should delight those interested in taxation. Readable style and lucid analysis have already made this 1977 Treasury Department study a classic. But do not expect everything. It is only 200 pages and readability takes a few words here and there. What is sacrificed is scope.

[1]E. S. Savas, *Privatizing the Public Sector: How to Shrink Government* (Chatham, N.J.: Chatham House Publishers, 1982).

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The book limits its discussion to two types of taxes: the comprehensive income tax and the cash flow tax—a tax on consumed income. Not surprisingly, the philosophical analysis of the ethics of taxation is omitted. Privatization and user fees are outside the work's scope. So is the "public goods" case for taxation, and the claim that a broader base lulls people into accepting higher levels of taxation. *Blueprints* alone will leave the reader crystal clear on some issues, but still ignorant of more important issues.

Of the two suggestions for reform, the comprehensive income tax is the traditional standard which guides the Reagan administration's current tax reform proposal. *Blueprints* was importantly innovative, however, in its proposal for a cash flow tax—explaining how a tax on consumed income could be implemented. Although the book does not explicitly advocate this consumption tax, the advantages of such a tax are clear. Readers who have not thought seriously about this approach to tax reform will find the book's views especially enlightening.

Despite important differences, the comprehensive income tax and the cash flow tax have many things in common. A tax on either base can be progressive or regressive, depending on the rate structure. An important feature of both is the elimination of the corporate income tax. In contrast to the popular corporation-bashing demagoguery, *Blueprints* explains the inefficiency of taxing income at the corporate level.

Taxes are judged on their simplicity, and the comprehensive income tax is not simple. Fringe benefits, sometimes arbitrarily valued, would be taxed. Business income—the depreciation and inventory problems of which create much of the complexity in current tax law—would still be measured and taxed. Capital gains would be taxed as ordinary income but indexed. Among the newly taxed items are employer-paid insurance premiums, "inside buildup" in whole-life policies, charitable donations, and unemployment compensation. The continued deductibility of state and local income taxes, however, suggests this is not base-broadening for its own sake. *Blueprints* explains why each should be considered "income."

Taxes are also judged on their efficiency, the extent to which they systematically avoid altering relative prices from those of a taxless world. The comprehensive income tax would retain, and even exacerbate, the principal inefficiency of any tax on income: the bias against saving. Either saving or its returns must be exempt from tax to avoid this bias. But saving is a use of income, and its returns are part of income, so both would be taxed under a comprehensive income tax. Nobody who understands how markets work would prefer a non-neutral tax biased toward saving. But for the same reasons there should be no bias against it.

The comprehensive income tax discussed in *Blueprints* is a fine one, but most readers will properly infer that all that is left to justify it is the third commonly used gauge, equity. Tax analysts have talked about equity and generally subdivide it into types, but they seem content to

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rely for its basic meaning on popular opinion. People who want to actually *like* taxes should probably be advised not to think too hard about equity. Anyway, the "equity" supporting the income tax, emphasizing progressivity and income redistribution, is—it seems to me—nothing but crude egalitarianism.

The cash flow tax, the book's better idea, is a bit different. Its tax base starts with all monetary receipts, and subtracts expenditures for saving and certain deductible items. One who receives a $1,000 paycheck and saves $175 in a "qualified" account is taxed only on $825, his "consumed income." If he were instead to augment his check with a $175 withdrawal, he would be taxed on $1,175. Deposits are considered saving and are exempt from taxation, while withdrawals are considered consumption and are taxed. Such saving is taxed once: at withdrawal. The cash flow tax extends to all saving our current law's treatment of individual retirement accounts (IRAs) and other retirement saving, but eliminates the penalties for early withdrawal.

"Qualified" accounts—those with government approval—may sound like a vehicle for the abuse of power. But other saving (gold coins, residential housing), while treated differently, is not treated worse. It is not deductible. It is considered consumption and is taxed when accumulated. When liquidated or withdrawn, though, only its earnings are taxed. After all, the tax on the principal has already been paid. The timing of payment of the tax is different, but its present value is the same as if a qualified account had been used. *Blueprints* illustrates the flexibility of combining qualified and unqualified accounts to smooth out tax liabilities over time. One might prepay the tax on the down payment for a house by saving in an unqualified account. Eager prospective homeowners who cannot resist the temptation to defer tax by saving in qualified accounts would find a sizable tax due when they withdraw such a substantial sum.

The cash flow tax would have many of the income tax's deductions, for the same reason: they are not consumption. But it would be much simpler by eliminating the complex computation of corporate income and the taxation of capital gains. Its great gain in efficiency—eliminating the bias against saving—also makes it more equitable. It adopts a lifetime perspective which renders "the expected present value of taxes paid [independent of] the time pattern of consumption" (p. 47).

Blueprints concludes with chapters on quantitative analysis and transition problems. Some of the latter require makeshift phase-in rules which would create short-run complexity. But the book does not shirk these difficulties, and this serves to emphasize that it is a fine example of how tax reform should be discussed.

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Theology, Third World Development and Economic Justice
Walter Block and Donald Shaw
Vancouver, Canada: The Fraser Institute, 1985, 125 pp.

Economic theory and theology have long clashed. Specifically, economic theory supporting a system of free enterprise has clashed with certain powerful segments of the religious leadership. One cannot doubt the animus much of the influential religious community holds for an economic system based on self-interest and the profit motive. Business enterprises, the organisms of that distrusted ecosystem, are seen, especially in their multinational forms, as exploitive forces of imperialism and militarism. The business community to a large extent has conceded the moral imperative and satisfied itself with apologetic testimony on the contributions industry makes to worthy charities such as public television. Putting a human face on capitalism has a role, but it can direct discussion away from the more fundamental issue of the moral foundation of alternative economic systems. The question, "Is the economic outcome of a free society just?" must be accompanied by a second query, "Are the economic outcomes of socialist or communist societies more just?"

The fact that economic theory and theology clash at all simply may be testimony to the persistence of scholarly misunderstanding. Milton Friedman once wrote that "differences about economic policy among disinterested citizens derive predominantly from different predictions about the economic consequences of taking action—differences that in principle can be eliminated by the progress of positive economics—rather than from fundamental differences in basic values, differences about which men can ultimately only fight."[1] Values, however, not the economic consequences of human action, have defined the debate.

Marxism and capitalism offer two quite different world views. Marxism on its face sells better because of the values it seems to hold dear. Economic injustice, once identified, is attacked frontally by the benevolent state. The market system pioneered by Adam Smith is condemned because it rejects collective efforts to promote the public interest as unnecessary and even counterproductive. It is not easy to understand just how the interplay of millions of individuals looking to their own self-interest can result in a satisfactory social system. Theologians find it difficult to endorse a system based on selfishness and greed. A morally acceptable system must allow for much more altruism and compassion generated by a public-regarding institution. The Marxian vision survives and even prospers among theologians despite its numerous well-known failures because it seems to provide explicit support for values they cherish. In short, they want it to work. The substantial success of the

[1]Milton Friedman, "The Methodology of Positive Economics," in *Essays in Positive Economics* (Chicago: University of Chicago Press; 1953), p. 5.

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Smithian vision is dismissed without a fair hearing and theologians are often prejudiced because of the support it appears to give to individualism, selfishness, and materialism.

The debate then centers on whether the Marxian or the Smithian vision better preserves the cherished values and more effectively achieves the desired goal of economic justice. The conference volume edited by Walter Block and Donald Shaw makes a worthy contribution to that debate. The volume does not dwell singularly on Third World development despite the presence of Lord Peter Bauer and the attention given to liberation theology. Economic justice generally is the dominant theme raised by the impressive list of participants.

Paul Heyne, a theologian and economist, considers the concept of economic justice. Justice is the first virtue of a social system. But because we are human and face imperfect knowledge, human justice must content itself with the avoidance of injustice. We cannot really say what the former is, but we can recognize the latter. How do we avoid injustice? By following the rules. What rules? The rules to which we have committed ourselves—rules which others expect us to follow because we have committed ourselves to follow. Rules are promises that members of a society have accepted, making up the social contract. They comprise obligations to one another. These obligations create rights. Human injustice then is promise-breaking. Justice then comes from the avoidance of injustice, including injustices done to some with the intention of showing compassion for others.

Father James Sadowsky extends Heyne's thesis. It is illegitimate or unjust to force an unwilling participant into an economic transaction. By the same logic, one has no right to stop consenting adults from engaging in mutually beneficial trade. "To say that the market is unjust is essentially to claim the right to ban voluntary transactions." Sadowsky rejects the idea that "property is theft"; an idea applied all too often in the Bible but one that is anachronistic in a system in which individuals become rich by means of producing goods and services freely traded to others. A restriction on the use of private property is really a claim by the restrictor to have the right to control it. This claim would have validity, Sadowsky points out, only if it were the restrictor's property. The question then becomes, how did it become this person's property since he or she did nothing to get it? In Sadowsky's view, property is justly acquired only if the owner claims what was previously unowned, and enhances the productivity of such property. He may also acquire property by voluntary exchange or request, but not by the use of coercion.

Unequal distribution is bound to arise in a voluntary exchange system. But, as Bauer points out, everybody is poor to begin with. That some people acquire property and wealth more quickly than others does not prevent others from becoming better off. Indeed, economic growth will tend to benefit all members of society. How far, Bauer asks, does a Christian's duty to share depend on the circumstances of the giver and

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recipient, and in particular on the conduct of the recipient? Does the destitute chronic gambler have the same claim to aid as does the individual stricken by illness? Should East African countries be given aid when they have expelled their most productive subjects causing immense hardship and reducing their per capita incomes? Aid only permits them to continue in this fashion.

Economic achievement depends, not on donated capital but on the conduct of people, including those in government. Official aid, that is government-to-government transfers, can have unexpected and adverse repercussions and is unlikely to relieve poverty or promote development. Providing aid to rulers in the Third World because their subjects are poor is entirely different from giving aid to the poor themselves. The urban bias of Third World economic policies means that official aid usually hurts the poorest, most notably the rural poor. Moreover, increasing the resources at the disposal of recipient governments inevitably reinforces the politicization of life in the Third World.

Ricard Hordern points out that liberation theologians seek no specific political or economic system, but rather a form of economy suited to their own context which will enhance the liberation of the people. He notes that it is not fair to equate liberation theology with Marxism, although most of its support is toward some form of socialism. The goal is a system that provides economic justice. He points out that economic injustice can be measured by income differences. Father Isidori Gorski summarizes succinctly the notion of the liberated society: "The basic test of economic policy is how it affects human persons—how it promotes or denies human dignity and the common good."

Accepting that goal, Walter Block points out that the means to that goal is problematic. What system most closely approaches that goal? Focusing on minimum wage laws, Block shows how well-intended government intervention often harms the very people it was meant to help. As Block notes, minimum wage laws typically harm the poorest members of the population by foreclosing productive and meaningful work options. Thus, despite the effort to use government to do good, society may well benefit by less rather than more government intervention. However, before a laissez-faire attitude is generally accepted by the electorate, voters must come to understand the long-run consequences of alternative policy measures, a slow educational process at best.

It is risky to bring together people who have much to say about an issue. You cannot tell a priori if the group will leave you with a set of unconnected thoughts or meld into a cogent and effective dialogue. Fortunately, Block and Shaw have produced the latter. Especially useful is the dynamic created by the audience. From professors of philosophy to grain farmers, the audience raised questions and concerns reflecting their varied experiences in the economic system in a way that nicely enhances the debate.

Robert A. Rogowsky
Economic Education for the Clergy

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Deregulating the Airlines
Elizabeth E. Bailey, David R. Graham, and Daniel P. Kaplan
Cambridge, Mass.: MIT Press, 1985, 225 pp.

Presidents may come and go, but the bureaucracy goes on forever, right? Well, not always. In 1984, which was supposed to be the year of Big Brother, we actually witnessed the demise of a major federal agency, the Civil Aeronautics Board (CAB).

Since its founding in 1938, the CAB told the airlines what fares they could charge and what routes they could serve. Although designed to protect the public, the regulated carriers were the winners under this system. Indeed, they were the principal lobbyists for establishing the CAB, and a former chairman of the agency once observed (without intended irony) that "If the CAB did not exist, the airlines would have had to invent it. And in point of fact, they did."

It is easy to see why the regulated airlines liked regulation. Entry into the industry was virtually blocked, and the CAB was stingy in giving an existing airline a license to enter another carrier's route. The CAB handed out generous rate increases every time the airlines bought too many new airplanes or found traffic falling off during a recession, and price competition was an alien concept. Interestingly enough, the intended beneficiaries of this system—small communities—did not fare all that well under regulation. Between 1960 and 1977, the CAB allowed regulated airlines to drop all service at 179 communities across America, hardly a model of sound, public-utility-style regulation.

It was this system that Congress set out to reform in 1978, and the prescription was remarkably simple. Get the CAB out of the business of regulating airline routes and rates; subsidize the smallest communities for 10 years, but do it more efficiently than in the past; and close the agency down by the end of 1984. And despite periodic cries for "reregulation" or "finetuning" the Airline Deregulation Act, that is exactly what happened. The CAB closed its doors at the end of 1984, and certain residual functions which were not deregulated (for example, small community subsidy, international aviation, consumer protection, and antitrust enforcement) were transferred to the Department of Transportation. Air safety, which is regulated by the Federal Aviation Administration, a separate agency, continues to be regulated in the same manner as it was prior to economic deregulation.

Airline deregulation has always been a controversial topic. When it was being debated in Congress, support came from an unlikely coalition which brought together such strange bedfellows as Ralph Nader's Aviation Consumer Action Project and the American Conservative Union, Common Cause and the National Taxpayers' Union, as well as such groups as the National Association of Manufacturers, the American Association of Retired Persons, and Sears Roebuck. Since the law was passed in 1978, the topic has remained controversial, partly because everyone

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who flies has an opinion on how well it has worked, and partly because the industry has undergone some radical changes since then.

The airline deregulation experiment is important, not only because it was the first time Congress lifted economic controls on a regulated industry, but also because the Airline Deregulation Act served as a model for later legislation which reformed economic regulation in other modes of the transportation industry. Thus, the experience under airline deregulation is interesting in its own right, as well as providing possible insights into other deregulatory initiatives.

This book makes an important contribution to public understanding of what airline deregulation is all about, and the authors are uniquely qualified to offer this perspective. Elizabeth E. Bailey is a professional economist (now dean of the graduate school of industrial administration at Carnegie-Mellon) who was a member of the CAB from 1977 to 1983. David R. Graham and Daniel P. Kaplan were senior staff members at the CAB during this period, and in December 1982 they published a comprehensive economic analysis of how the act has worked, which provides the analytical foundation for this book.

The authors trace the origins of airline regulation, how it worked for 40 years, and why Congress changed the law in 1978. Then they get to the heart of their book, which is what happened during the first few years under deregulation. Perhaps not surprisingly, the authors regard the deregulation experiment as a success in terms of achieving its goals of increasing airline competition and productivity, offering consumers more choices when they need to fly. Specifically, they conclude that "productivity and service convenience are improving and that over the long run consumers can expect to pay lower fares than they would have in a regulated regime."

The book is not a puff piece, however. It acknowledges that there have been winners and losers, and the authors are careful to outline the pros and cons of deregulation and to offer economic analysis to explain why things have happened the way they did.

For instance, take the familiar example that transcontinental travelers have benefited from $99 fare wars, while travelers on smaller carriers flying a fraction of the distance pay twice as much if not more. The authors point out the economics of why this phenomenon has occurred. Prior to deregulation, the CAB required airlines to set their coach fares according to a formula that was based strictly on how far an individual was flying. There were several key problems with this formula, however. First, it pegged fares too high on long-distance flights, so these fares logically fell once they were decontrolled. Second, the CAB formula assumed that distance was the key factor in setting fares, ignoring the fact that dense markets (such as New York–Los Angeles) were less expensive to serve, mile per mile, than short, thin routes. Add to that the fact that when deregulation occurred, the airlines had an excess of wide-body jets on their hands, which they found cheaper to fill through mar-

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ginal pricing, and you have some idea why fare wars have broken out on these longer routes.

By contrast, short-haul flights (especially on small commuter airlines) are more expensive to operate, mile per mile, partly because there is less traffic and partly because short-haul flights are inherently more costly than long-distance flights. Also, short commuter flights tend to be used primarily by time-sensitive travelers who strongly value the convenience of a 45 minute flight over a three hour drive and may be willing to pay a premium for this service. Some critics charge that this disparity is not "fair," but the result does reflect a key conclusion of the authors, namely, that the competitive pressures spawned by deregulation seem to be pushing airline fares more closely in line with the actual cost of providing service.

This example illustrates what is perhaps the principal value of this book, both for students of regulation in general, as well as people who want to understand the airline deregulation phenomenon in particular. It offers an economically rigorous explanation not only of fare wars, but of other key developments, such as why "hub and spoke" route networks evolved; why some small communities gained and why others lost service; why airline employees have accepted wage freezes and cutbacks; and how new airlines such as People Express have changed the industry.

Although the authors had a bird's eye view of how deregulation unfolded, this book is not written as an "inside" account of what the CAB was doing during this critical transition period. Instead, the authors explain what the CAB did during this period and how the airlines reacted to their new freedom, and they are content to let the economic data speak for itself. Although the authors bring an economic perspective to this work, it is written in a straightforward style that should be accessible to nonspecialists.

Much of the economic data that is examined here is from the 1978–81 time frame, thus reflecting the early experience under deregulation. The authors chose this cutoff primarily to avoid distortions caused by the air traffic controllers strike in 1981. The authors argue (I believe correctly) that the experience during the economic recovery bolsters the qualitative conclusions about deregulation, and they occasionally refer to more recent data. I would have preferred to see more of that data in the text, but this is a quibble.

Perhaps wisely, given the economic uncertainty of recent years, the authors refrain from trying to gaze into the crystal ball and to predict what changes lie ahead. They do briefly mention some of the emerging competitive issues in the industry, such as limitations on airport capacity, and the ability of United and American to bias their computer reservation systems against the interests of smaller carriers, although the analysis of these points is not particularly detailed.

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In any event, this book succeeds in answering the question, "Are air travelers better off today than they were seven years ago?" The authors provide some solid reasons why the answer is "yes."

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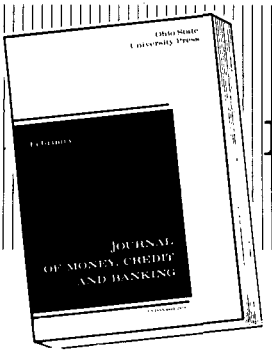

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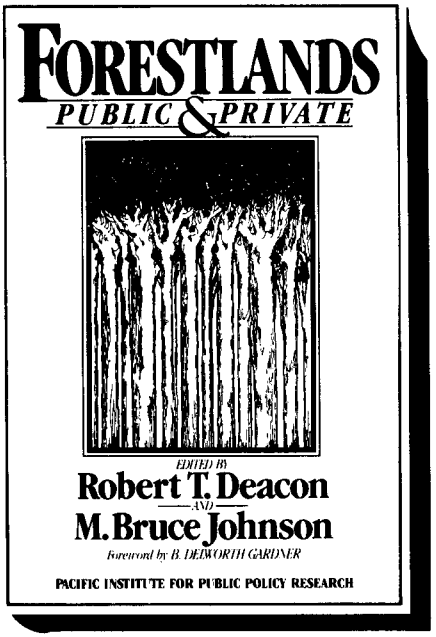

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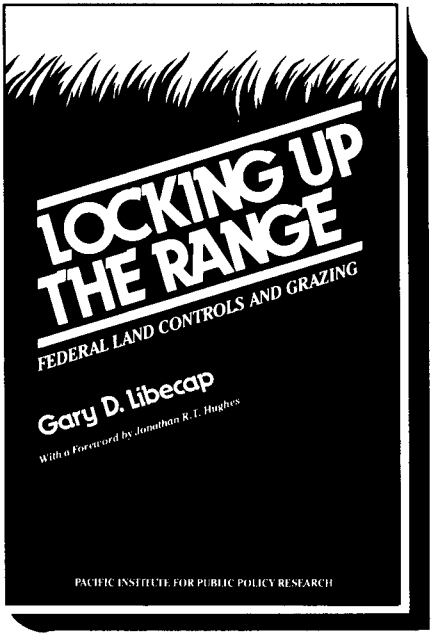
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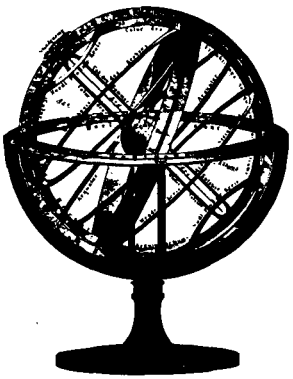

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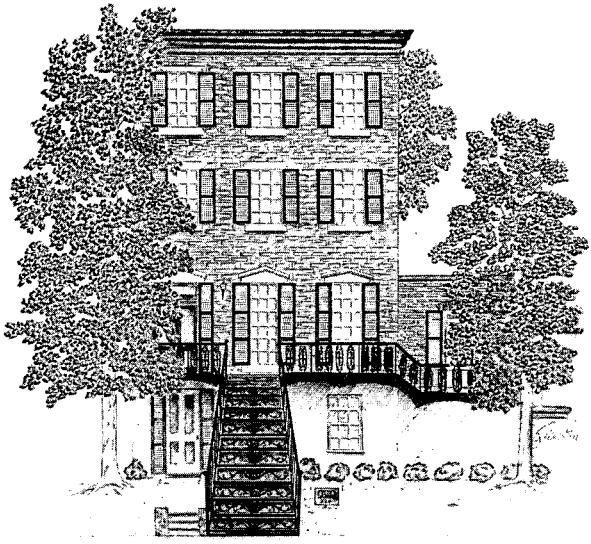

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—James M. Buchanan

Public Finance in Democratic Process (Chapel Hill, University of North Carolina Press, 1967), pp. 299–300.

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